(16)

No. 93-404-CFX
Status: GRANTED

Title: Arthur L. Gustafson, et al., Petitioners
v.
Alloyd Company, Incorporated fka Alloyd Holdings, Incorporated, et al.

Docketed:
September 9, 1993

Court: United States Court of Appeals for the Seventh Circuit

See also:
93-201

Counsel for petitioner: Skoning,Gerald D., Wheeler,Harold

Counsel for respondent: Kopecky,Robert J., O'Brien,Karen M., Solicitor General, Cafferty,Patrick E.

Ptn due & mld 9-9-93, see ml label re dkt dt.

Entry	Date	Note	Proceedings and Orders
1	Sep 9 1993	G	Petition for writ of certiorari filed.
3	Oct 5 1993		Order extending time to file response to petition until November 10, 1993.
4	Nov 10 1993		Brief of respondents Alloyd Co., Inc., et al. in opposition filed.
5	Nov 17 1993		DISTRIBUTED. December 3, 1993 (Page 1)
6	Nov 30 1993	D	Motion of petitioners to consolidate this petition with 93-201, Allen & Company v. Pacific Dunlop filed.
7	Dec 2 1993		Opposition of respondent in 93-201, Pacific Dunlop Holdings Inc. to motion of petitioners filed.
14	Dec 8 1993		Opposition of Alloyd Co.Inc., and Wind Point Partners II, L.P. to motion of petitioners filed.
9	Dec 13 1993		Brief of petitioner Allen & Company Incorporated in response to motion for consolidation filed.
10	Jan 5 1994		REDISTRIBUTED. January 21, 1994 (Page 1)
11	Jan 24 1994		Motion of petitioners to consolidate this petition with 93-201, Allen & Company v. Pacific Dunlop DENIED.
12	Feb 28 1994		REDISTRIBUTED. March 4, 1994 (Page 13)
13	Mar 7 1994		Petition GRANTED.
			**
16	Apr 7 1994		Order extending time to file brief of petitioner on the merits until May 6, 1994.
17	May 6 1994		Joint appendix filed.
18	May 6 1994		Brief of petitioners filed.
19	May 6 1994		Brief amicus curiae of Securities Industry Association, Inc. filed.
22	May 17 1994	G	Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed.
21	May 18 1994		Order extending time to file brief of respondent on the merits until June 29, 1994.
23	Jun 27 1994		Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument GRANTED.
24	Jun 29 1994		Brief amicus curiae of respondent North American Securities Administrators Association, Inc. filed.
25	Jun 29 1994		Brief amicus curiae of Securities & Exchange Commission filed.

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No. 93-404-CFX

Entry	Date	Note	Proceedings and Orders
26	Jun 29 1994		Brief of respondents Alloyd Co., Inc., et al. filed.
27	Jun 29 1994		Brief amicus curiae of respondent National Assn. of Securities and Commercial Law Attorneys filed.
28	Jul 15 1994		CIRCULATED.
30	Aug 1 1994	X	Reply brief of petitioners filed.
31	Aug 4 1994		Record filed.
		*	Partial proceedings United States Court of Appeals for the Seventh Circuit.
33	Sep 8 1994		The parties are ordered to file on or before Tuesday, October 11, 1994, supplemental briefs addressing the question whether Section 12(2) of the 1933 Securities Act applies to secondary transactions as well as to initial offerings of securities. Oral argument in this case, presently scheduled for October 11, 1994, is postponed.
32	Sep 12 1994		SET FOR ARGUMENT WEDNESDAY, NOVEMBER 2, 1994.(3RD CASE).
34	Oct 11 1994	X	Supplemental brief of petitioners filed.
35	Oct 11 1994	X	Supplemental brief of respondents filed.
36	Oct 25 1994		Record filed.
		*	Original record proceedings United States District Court, Northern District of Illinois (SEALED ENVELOPES)
37	Nov 2 1994		ARGUED.

93-404

No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

ARTHUR L. GUSTAFSON, DANIEL R. McLEAN and FRANCIS I. BUTLER,

Petitioners,

v.

ALLOYD CO., INC. and WIND POINT PARTNERS II, L.P.,

Respondents.

Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

PETITION FOR WRIT OF CERTIORARI

GERALD D. SKONING*
HAROLD C. WHEELER
PETER C. WOODFORD
DEBRA A. WINIARSKI
SEYFARTH, SHAW, FAIRWEATHER & GERALDSON
55 East Monroe Street
Suite 4200
Chicago, Illinois 60603
(312) 346-8000

Counsel for Petitioners Daniel R. McLean and Francis I. Butler

DONALD W. JENKINS
THOMAS P. DESMOND
ANDREW M. GARDNER*
MICHAEL L. KAYMAN
VEDDER, PRICE, KAUFMAN & KAMMHOLZ
222 North LaSalle Street
Suite 2600
Chicago, Illinois 60601
(312) 607-7500

Counsel for Petitioner Arthur L. Gustafson

* *Counsel of Record*

Midwest Law Printing Co., Chicago 60611, (312) 321-0220

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QUESTION PRESENTED

Whether Section 12(2) of the Securities Act of 1933 is applicable to a privately negotiated resale of all the stock of a corporation.

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PETITION FOR WRIT OF CERTIORARI

Petitioners, Arthur L. Gustafson, Daniel R. McLean and Francis I. Butler, respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit entered in this proceeding on June 11, 1993.

OPINIONS BELOW

The order of the United States Court of Appeals for the Seventh Circuit is not reported. It is included in the Appendix hereto at App. 1. The opinion of the United States District Court for the Northern District of Illinois is also not reported. It is included in the Appendix hereto at App. 3.

JURISDICTIONAL STATEMENT

Invoking federal jurisdiction under 28 U.S.C. §1331, Respondents brought suit under Section 12(2) of the Securities Act of 1933, 15 U.S.C. §77l(2) ("Section 12(2)"), in the United States District Court for the Northern District of Illinois. On May 29, 1992, the district court, ruling that Section 12(2) does not apply to the transaction at issue, granted Petitioners' motion for summary judgment.

On Respondents' appeal, the United States Court of Appeals for the Seventh Circuit, on June 11, 1993, entered a judgment ordering the district court's order vacated and remanding this case to the district court for further proceedings in light of the Seventh Circuit's opinion in *Pacific Dunlop Holdings Inc. v. Allen & Co. Inc.*, 993 F.2d 578 (7th Cir. 1993) (holding Section 12(2) applies to secondary market transactions), *petition for cert. filed*, 62 U.S.L.W. 3144 (U.S. Aug. 24, 1993) (No. 93-201). No petition for rehearing was sought.

This petition for certiorari is filed within 90 days of the Seventh Circuit's June 11, 1993, judgment. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

STATUTE INVOLVED

This case involves Section 12(2) of the Securities Act of 1933, 15 U.S.C. §77l, which provides as follows:

Civil Liabilities Arising in Connection
With Prospectuses and
Communications

Sec. 12. Any person who—

(1) offers or sells a security in violation of section 5, or

(2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

STATEMENT OF THE CASE

This case arises out of the December 1989 sale of the stock of Alloyd Co., Inc. ("Alloyd") pursuant to a privately negotiated stock purchase agreement (the "Agreement"). Respondents ("Buyers") claim that material misrepresentations were made in connection with the sale in violation of Section 12(2) and in breach of the Agreement.

Alloyd is a manufacturer of clear plastic blister packaging and automatic heat seal packaging equipment. Alloyd's stock has been outstanding since 1961. In 1989, Arthur L. Gustafson ("Gustafson"), Daniel R. McLean ("McLean"), and Francis I. Butler ("Butler") (collectively "Sellers") were Alloyd's sole shareholders. In the spring of 1989, KPMG Peat Marwick ("KPMG") was retained to find a buyer for Sellers' Alloyd stock. A "Profile" was distributed to prospective buyers providing extensive information relating to Alloyd, including historical and budgeted financial information. The Profile stated that the budgeted 1989 information was unaudited and that "the actual results achieved may vary from the prospective financial results and the variations could be material."

A copy of the Profile was sent to Respondent, Wind Point Partners II, L.P. ("Wind Point"), an experienced and sophisticated venture capital investment partnership. Wind Point visited Alloyd's facilities and reviewed extensive additional information relating to Alloyd.

In October, 1989, Sellers agreed in principle to sell their Alloyd stock to Alloyd Holdings, Inc. ("Holdings), a corporation to be formed by Wind Point to effectuate the purchase. McLean and Butler agreed to invest about $1,500,000 for a minority interest in Holdings and become officers and directors.

While negotiating the Agreement, Wind Point conducted extensive due diligence. KPMG was retained by Wind Point to conduct a business review of Alloyd and perform other procedures relating to Alloyd's interim financial statements. The interim financial statements included estimated components consistent with Alloyd's historical performance affecting Alloyd's cost of goods sold and, thus, gross profit. KPMG informed Wind Point in writing that:

> Because of the size of the accounting/finance staff of the company, there is limited in-house analysis of the financial results on either a monthly or yearly basis. As a result, significant adjustments to the financial statements are typically made by the external accounting firm at year-end.

KPMG's report to Wind Point detailed how Alloyd adjusted its inventory at year-end when an actual audit occurred, stating that "Alloyd's year-end adjustments to inventory have been material in past years."

Alloyd's estimated inventory was discussed extensively during Wind Point's due diligence. Wind Point knew that Alloyd had an unreliable inventory control system and that the only way to determine Alloyd's actual inventory would be to take a physical inventory. KPMG told Wind Point that without an audit or inventory count there would be no way of knowing how large Alloyd's inventory adjustment would be at year-end. Wind Point decided not to take a physical inventory or conduct an audit prior to the closing on the sale. Buyers decided to close the transaction without an audit or physical inventory, paying an estimated purchase price at closing to be adjusted after an audit of Alloyd's year-end financial statements.

Sellers' representations in the Agreement regarding Alloyd's interim financial statements were carefully negotiated and modified in drafts of the Agreement. Early language stating that Alloyd's interim financial statements presented Alloyd's financial condition "accurately and completely", was revised in the final Agreement to state that the interim financial statements "present fairly" Alloyd's financial condition. The final Agreement added a specific reference to notes to Alloyd's unaudited interim financial statements, which notes stated that inventory and certain accrued expenses were estimated and subject to adjustment at year-end.

The Agreement was executed as of December 20, 1989, and the transaction closed on December 22, 1989, when Holdings purchased Sellers' stock for $18,709,000 plus a payment of $2,122,219 reflecting an estimate of Alloyd's increase in net worth from December 31, 1988, through the closing. The Agreement required that Sellers or Buyers remit an appropriate amount to cover any variance between the estimated increase in net worth and the actual increase after the year-end audit of Alloyd's financial statements. After KPMG took a physical inventory as part of its audit of Alloyd's December 31, 1989 financial statements, Sellers paid Holdings $815,000 plus interest to cover the difference between the estimated amount paid at the closing and the actual amount due pursuant to the Agreement.

On February 11, 1991, Buyers instituted this case alleging that Sellers misrepresented Alloyd's interim financial condition in violation of Section 12(2) and that Sellers breached the Agreement.

The district court's May 29, 1992 Memorandum Opinion and Order granted Sellers' motion for summary judgment

as to Buyers' Section 12(2) claim, noting that the Alloyd securities involved in this transaction had been outstanding for approximately 30 years, the sale of the securities was a negotiated resale to a single buyer, and Wind Point was an experienced investor with direct access to information regarding Alloyd. The court concluded that Section 12(2) did not apply because the transaction was not an initial distribution and did not possess the characteristics of an initial offering. In doing so, the court agreed with the Third Circuit's analysis in *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 693 (3rd Cir.) *cert. denied,* 112 U.S. 79 (1991), which had held that:

> In sum, the language and legislative history of section 12(2), as well as its relationships to Sections 17(a) and 10(b) within the scheme of the 1933 and 1934 Acts, compel our conclusion that Section 12(2) applies only to initial offerings and not to aftermarket trading.

When Buyers appealed to the Seventh Circuit, briefing and argument was held in abeyance pending resolution of the appeal in *Pacific Dunlop Holdings Inc. v. Allen & Co. Inc., supra.* After reversing the district court in *Pacific Dunlop*, the Seventh Circuit, on June 11, 1993, vacated without opinion the district court's Order in this case and remanded the case for further consideration in light of *Pacific Dunlop*. Petitioners appeal from that judgment of the Seventh Circuit.

REASONS FOR GRANTING THE WRIT

Review by writ of certiorari is a matter of judicial discretion which should be favorably exercised as to a substantial question of federal law when a conflict exists between or among United States Courts of Appeals which creates confusion among the lower courts. *See Insurance Corp. of Ireland v. Compagnie des Bauxites*, 456 U.S. 694, 700 (1982); *United States v. Lorenzetti*, 467 U.S. 167, 173 (1984); *McElroy v. United States*, 455 U.S. 642, 643 (1982). This case meets these requirements.

I.

Whether Section 12(2) Applies To Privately Negotiated Secondary Transactions Is A Substantial Question Of Federal Law.

Section 12(2) is a unique provision in the securities laws which provides that buyers of securities may, if sellers make an unintentional misrepresentation by means of a prospectus, rescind the transaction. The cause of action created by Section 12(2) is more akin to one for negligent misrepresentation than to fraud covered by Section 17 of the 1933 Act (15 U.S.C. §77q) and Section 10(b) of the 1934 Act (15 U.S.C. 78j(b)) and Rule 10b-5 thereunder (17 C.F.R. §240.10b-5 (1992)). Indeed, courts have concluded that material misrepresentations render sellers "strictly liable" under Section 12(2). *Capri v. Murphy*, 856 F.2d 473, 478 (2d Cir. 1988).

Privately negotiated secondary market transactions with sophisticated buyers typically involve extensive due diligence, negotiation with regard to representations and warranties, and allocation of risks frequently associated with the transaction. Whether, notwithstanding such due diligence, negotiation, and allocation of risk, Section 12(2) allows buyers to rescind based on an unintentional misrepresentation is a matter of critical importance to the negotiation and structuring of such transactions.

This Court has previously acknowledged the importance of certainty in application of the federal securities laws, stating: "uncertainties attending the applicability of the Acts would hardly be in the best interest of either party to a transaction." *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 696 (1985). As discussed below, the Seventh and Third Circuits are in conflict on the question presented by this petition and uncertainty will continue to exist in circuits which have not addressed the question.

The transaction at issue here involved the resale of long-issued stock to sophisticated buyers pursuant to a negotiated agreement to close without a physical inventory or audited financial statements using an estimated purchase price to be adjusted after an audit. If Sellers breached the Agreement, Buyers have a remedy under the Agreement. The important question of federal law which prompts this petition is whether sellers in this type of transaction are also liable for rescission or rescissionary damages under the strict liability rationale of Section 12(2).

The trial court and the Third Circuit held Section 12(2) does not apply to this type of secondary transaction. In *Pacific Dunlop*, the Seventh Circuit ruled that Section 12(2) applies to all secondary market transactions. Which interpretation is correct is of critical importance affecting thousands of negotiated transactions annually, because certainty will permit contracting parties to determine requisite due diligence and allocate risk by agreement. This Court should grant certiorari to resolve the important question of federal law presented in this case.

II.

Direct Conflicts Exist Among Numerous Courts Regarding This Question.

In *Ballay*, the Third Circuit held that Section 12(2) applies only to initial distributions, not to aftermarket trading, based on "the language and legislative history of Section 12(2), as well as its relationships to Sections 17(a) and 10(b) within the scheme of the 1933 and 1934 Acts." *Ballay*, 925 F.2d at 693.

The Seventh Circuit in *Pacific Dunlop* held that Section 12(2) applies to secondary market transactions in addition to initial offerings, acknowledging that its holding was squarely at odds with that of the Third Circuit in *Ballay*: "[W]e depart from the Third Circuit and hold that Section 12(2) includes secondary market transactions." 993 F.2d at 582. Plainly, an irreconcilable conflict exists between these Circuit Courts.

Other circuits also have, by implication, addressed this issue with conflicting and confusing results. In *Gross v. Diversified Mortgage Investors*, 431 F. Supp. 1080 (S.D. N.Y. 1977), *aff'd mem.*, 636 F.2d 1201 (2d Cir. 1980), the court affirmed the district court's dismissal of a Section 12(2) claim based on a secondary market transaction because Section 12(2) only protects purchasers of stock sold pursuant to a misleading prospectus, which the court found is only used with respect to an initial offering. In contrast, in *Cady v. Murphy*, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940), the court upheld a Section 12(2) claim where the sale involved outstanding stock, though neither the parties nor the court directly addressed whether Section 12(2) applies solely to initial offerings. Similarly, in *Woodward v. Wright*, 266 F.2d 108 (10th Cir. 1959), the court, although not directly addressing whether 12(2) applies solely to initial offerings, upheld a Section 12(2) claim where the securities were sold in a secondary transaction.

The applicability of Section 12(2) to secondary market transactions has been inconsistently addressed by at least 30 reported district court opinions. The substantial majority of these opinions favor limiting Section 12(2) to initial distributions, utilizing numerous rationales to reach this conclusion.[1] Other courts have concluded to the contrary, permitting application of Section 12(2) to secondary

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[1] *Bogart v. Shearson Lehman Bros., Inc.*, 1993 U.S. Dist. LEXIS 1182 (S.D.N.Y. 1993); *Budget Rent A Car Systems, Inc. v. Hirsch*, 810 F. Supp. 1253 (S.D. Fla. 1992); *Comeau v. Rupp*, 810 F. Supp. 1127 (D. Kan. 1992); *Hedden v. Marinelli*, 796 F. Supp. 432 (N.D. Cal. 1992); *Newman v. Comprehensive Care Corp.*, 794 F. Supp. 1513 (D. Or. 1992); *In re Delmarva Securities Litigation*, 794 F. Supp. 1293 (D. Del. 1992); *Bennett v. Bally Mfg. Corp.*, 785 F. Supp. 559 (D.S.C. 1992); *Professional Serv. Indus., Inc. v. Kimbrell*, 1992 WL 403639 (D. Kan. 1992); *Cox v. Eichler*, 765 F. Supp. 601 (N.D. Cal. 1990); *Bank of Denver v. Southeastern Capital Group, Inc.*, 763 F. Supp. 1552 (D. Colo. 1991); *T. Rowe Price New Horizons Fund, Inc. v. Preletz*, 749 F. Supp. 705 (D. Md. 1990); *Grinsell v. Kidder, Peabody & Co.*, 744 F. Supp. 931 (N.D. Cal. 1990); *Leonard v. Stuart-James Co.*, 742 F. Supp. 653 (N.D. Ga. 1990); *Mix v. E.F. Hutton & Co.*, 720 F. Supp. 8 (D.D.C. 1989); *First Union Brokerage v. Milos*, 717 F. Supp. 1519 (S.D. Fla. 1989); *McCowan v. Dean Witter Reynolds, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,423 (S.D.N.Y. Apr. 11, 1989); *Cheltenham Bank v. Drexel Burnham Lambert, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,391 (E.D.N.C. Feb. 15, 1989); *Strong v. Paine Webber, Inc.*, 700 F. Supp. 4 (S.D.N.Y. 1988); *Ralph v. Prudential-Bache Sec. Inc.*, 692 F. Supp. 1322 (S.D. Fla. 1988); *Leonard v. Shearson Lehman/Am. Express, Inc.*, 687 F. Supp. 177 (E.D. Pa. 1988); *SSH Co. v. Shearson Lehman Bros., Inc.*, 678 F. Supp. 1055 (S.D.N.Y. 1987); *Ackerman v. Clinical Data, Inc.*, [1985-86 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶92,207 (S.D.N.Y. July 8, 1985); *Klein v. Computer Devices*, 591 F. Supp. 270 (S.D.N.Y. 1984), *clarified on reh'g*, 602 F. Supp. 837 (S.D.N.Y. 1985); *Gross v. Diversified Mortgage Investors*, *supra*.

market transactions under various rationales.[2] Securities law scholars and commentators also disagree as to whether Section 12(2) applies to secondary market transactions in addition to initial distributions.[3]

Certiorari should be granted, in light of these numerous conflicts, to resolve this important question.

III.

The Decision of the District Court Should be Reinstated.

Section 12(2) only provides a remedy against "Any person who offers or sells a security . . . by means of a prospectus or oral communication. . . ."[4] The district court's

[2] *PPM Am., Inc. v. Marriott Corp.*, 1993 U.S. Dist. LEXIS 5914 (D. Md. 1993); *Farley v. Baird, Patrick & Co.*, 750 F. Supp. 1209 (S.D.N.Y. 1990); *Folger Adam Co. v. PMI Indus., Inc.*, 1990 U.S. Dist LEXIS 3349 (S.D.N.Y. 1990); *In re Ramtek Securities Litigation*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,483 (N.D. Cal. Sept. 7, 1990); *Elysian Fed. Sav. Bank v. First Interregional Equity Corp.*, 713 F. Supp. 737 (D.N.J. 1989) (overruled by *Ballay*); *Wilko v. Swan*, 127 F. Supp. 55 (S.D.N.Y. 1955).

[3] *Compare* Weiss, *The Courts Have it Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 Bus. Law. 1 (1992), and Prentice, *Section 12(2): A Remedy for Wrongs in the Secondary Market?*, 55 Alb. L. Rev. 97 (1991), *with* Loss, *The Assault on Securities Act Section 12(2)*, 105 Harv. L. Rev. 908 (1992), and Maynard, *Liability Under Section 12(2) of the Securities Act of 1933 for Fraudulent Trading in Post Distribution Markets*, 32 Wm. & Mary L. Rev. 847 (1991).

[4] The term "oral communication" does not broaden the meaning of "prospectus" or the application of Section 12(2) to secondary market transactions. While the 1933 Act does not define "oral communication," judicial interpretation has properly restricted the term to oral communications relating to or connected with a prospectus. *Pacific Dunlop*, 993 F.2d at 588; *Ballay*, 925 F.2d at 688. *See also Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 8 (1985) (words grouped in a list are given related meaning).

holding that Section 12(2) does not afford a remedy to Buyers as to this privately negotiated transaction is in accord with the plain meaning of Section 12(2), which, by its use of "prospectus", does not connote a negotiated private resale of securities. The Agreement here does not comport with any obvious interpretation of the word "prospectus". It was not a communication device designed to entice buyers. Rather, the Agreement set forth the negotiated terms upon which the purchase would take place.

That Section 12(2) should not be read expansively to apply to the transaction at issue here is confirmed by the primary purpose of the 1933 Act, the legislative history attendant to its adoption, the structure of the 1933 Act and the additional remedies afforded by the 1934 Act. "The primary purpose of the 1933 Act was the regulation of the distribution of securities. Post-distribution trading is regulated by the 1934 Act." L. Loss, *Fundamentals of Securities Regulation*, 92 (1983). "The 1933 Act is . . . chiefly concerned with disclosure and fraud in connection with offerings of securities primarily, as here, initial distributions of newly issued stock from corporate issuers." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752 (1975). *See also Pinter v. Dahl*, 486 U.S. 622, 638 (1988) (primary purpose of the 1933 Act is protection of investors through disclosure allowing informed investment decisions concerning public offerings of securities).

The House Report accompanying the 1933 Act stated this primary purpose in the clearest terms:

> The bill affects only new offerings of securities sold through the use of the mails or of instrumentalities of interstate or foreign transportation or communication. It does not affect the ordinary redistribution of securities unless such redistribution takes on the characteristics of a new offering. . . .

H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933). As to the civil liability provisions of Sections 11 and 12 of the 1933 Act in particular, the Report stated:

> The committee emphasizes that these liabilities attach only when there has been an untrue statement of material fact or an omission to state a material fact in the registration statement or the prospectus—the basic information by which the public is solicited.

H.R. Rep. No. 85, 73d Cong., 1st Sess. 9 (1933).

Consideration of Section 12(2) in the context of the other provisions of the 1933 Act also demonstrates that, by its use of the word "prospectus", Section 12(2) applies only to transactions taking on the characteristics of an initial offering. The provisions of 1933 Act are primarily concerned with requiring and regulating disclosure in two documents—registration statements and prospectuses. Under Section 5 (15 U.S.C. §77e) a person may not, absent an appropriate exemption, offer or sell a security by means of a prospectus without filing a registration statement. *See A.C. Frost & Co. v. Coeur D'Alene Mines Corp.*, 312 U.S. 38, 41-42 (1941). Accordingly, the phrase "by means of a prospectus" has meaning in the 1933 Act primarily in the context of a distribution of securities pursuant to a registration statement.[5] Sections 5 through 7 (15 U.S.C. §§77e-g) detail the contents and proper use of a registration statement and the related prospectus in connection

[5] The term "prospectus" appears forty-two (42) times in the text of the 1933 Act. While Section 2(10) defines broadly the various forms which a prospectus may take, it does not change the fact that fundamentally a prospectus is a document "which offers any security for sale or confirms the sale of any security" after a registration statement is filed. 15 U.S.C. §77b(10).

with such a distribution and Section 10 (15 U.S.C. §77j) sets forth the information required in the prospectus.

The remedial provisions in the 1933 Act are Sections 11, 12 and 17. Section 12(2) must be read in the context of its placement in the 1933 Act and in comparison to the Act's other remedial provisions. *Dole v. United Steel Workers of America*, 494 U.S. 26, 36 (1990). Section 11 (15 U.S.C. §77k) provides for civil liability on account of false registration statements. Section 12 provides for civil liability arising in connection with prospectuses and communications. Section 12(1) provides a remedy where the seller violates the solicitation and sale requirements of Section 5 and Section 12(2) provides a remedy when a person offering or selling a security makes a misrepresentation "by means of a prospectus or oral communication". Section 12(1)'s direct reference to the registration requirement of Section 5 makes clear that Section 12 is focused on remedying abuses in the initial distribution process. Given its position in the same section and particularly its use of "prospectus", Section 12(2) cannot reasonably be construed as applicable to secondary transactions while the closely related Section 12(1) plainly applies only to initial distributions.

In contrast to Sections 11 and 12, Section 17(a) of the 1933 Act is phrased broadly proscribing fraud in the offer or sales of any securities in language which differs significantly greatly from the specific phrase "offers or sells . . . by means of a prospectus or oral communication" used in Section 12(2). In *United States v. Naftalin*, 441 U.S. 768, 777-778 (1979), the Court observed that: "Unlike much of the rest of the Act, [Section 17(a)] was intended to cover any fraudulent scheme in the offer or sale of securities, whether in the course of an initial distribution or in the course of ordinary market trading."

Unlike the legislative history of Section 12(2), the legislative history of Section 17(a) explicitly demonstrates an intention to apply that Section to transactions in both the primary and secondary securities market. "The act subjects the sale of old or outstanding securities to the same criminal penalties and injunctive authority for fraud, deception, or misrepresentation as in the case of new issues . . . ." S. Rep. No. 47, 73d Cong., 1st Sess. 4 (1933).

That Sections 11 and 12 apply only to initial distributions is also evidenced by the fact that both sections provide a remedy only to a buyer. This is consistent with the Act's primary purpose since the prospectus and registration statement are selling documents prepared by the seller. In the context of initial distributions, the provision of a remedy for misled buyers and the absence of any remedy for misled sellers makes complete sense because only buyers can be injured by misrepresentations in an initial distribution context. In contrast, in a negotiated private resale, there are representations and warranties by buyers and sellers. It makes no sense, in such a transaction, for a buyer to have available the extraordinary remedy of rescission while sellers are granted no remedy as to the same transaction.

A buyer can recover under Section 12(2) simply by showing that the seller misstated or failed to state a material fact. The buyer need not prove scienter, reliance or loss causation. *See, e.g.*, *Ballay*, 925 F.2d at 689 (negligent misrepresentation is actionable under Section 12(2)); *Wilson v. Saintine Exploration & Drilling Corp.*, 872 F.2d 1124, 1126 (2d Cir. 1989) (proof of scienter or loss causation is not required by Section 12(2)); *Capri v. Murphy*, 856 at 478 (material misrepresentation renders sellers strictly liable under Section 12(2)).

The extension of Section 12(2) and its much less stringent standards of liability to all secondary transactions would afford all buyers, and only buyers, a remedy which effectively renders superfluous, whenever a buyer sues, Rule 10b-5 and years of precedent with respect to scienter, reliance, and loss causation under that Rule. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (under Section 10(b) plaintiff must establish, *inter alia*, that defendant acted recklessly or with an intent to deceive known as scienter); *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981) (Section 10(b) imposes upon the plaintiff a stringent reliance requirement), *cert. denied*, 455 U.S. 938 (1982); *Sims v. Faestel*, 638 F. Supp. 1281 (E.D. Pa. 1986) (plaintiff in Section 10(b) claim must establish direct causal relationship between alleged misrepresentation and loss), *aff'd*, 813 F.2d 399 (3d Cir. 1987).

The different remedies available under Section 12(2) and Section 10(b) further support the conclusion that Section 12(2) is limited to initial distributions. Section 12(2) provides for rescission or rescissionary damages, *see Pinter v. Dahl*, *supra*, while Section 10(b) permits recovery only of actual damages. *See Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972). A seller in an initial distribution should bear liability for rescission or rescissionary damages because the seller receives the full purchase price from the buyer and is the buyer's sole source of information concerning the value, risk, and quality of the security. The rescission remedy without scienter, reliance, or causation proof afforded by Section 12(2) is consistent with the congressional purpose of regulating and promoting full disclosure in initial distributions by forcing disgorgement of the entire amount the seller received irrespective of the damages actually suffered by the buyer. The same is not true in a privately negotiated secondary

market transaction where the buyer has independent market information, access to the seller's financial and operational records, and the ability to negotiate the terms of the acquisition and allocate risks by agreement. In such transactions, the remedy should be limited to the actual loss sustained, the remedy afforded by Section 10(b) of the 1934 Act and Rule 10b-5. Application of Section 12(2) to all secondary market transactions would undermine this proper allocation of remedies.

In sum, the language of Section 12(2), the purpose and structure of the 1933 Act, the legislative history of the Act and Section 12(2) and the interplay between the 1933 Act and the 1934 Act all demonstrate that Section 12(2) was not intended to apply to a privately negotiated resale of stock.

IV.

The Seventh Circuit's Broad Application of Section 12(2) is Not Warranted by its Language or the Structure or Purpose of the 1933 Act.

In *Ballay*, the court observed that "Congress repeatedly used the term 'prospectus' in provisions concerning registration statement requirements in initial distributions." 925 F.2d at 689. Pursuant to this analysis, the Third Circuit held "Congress employed the term 'prospectus' as a term of art which describes the transmittal of information concerning the sale of a security in an initial distribution." *Id.* at 688. As the Third Circuit observed, if Congress had intended a more expansive meaning for Section 12(2), it "more simply could have drafted Section 12 to describe all written or oral communications." *Id.* at 689. Congress' use of the more restrictive phrase "by means of a prospectus" evidences convincingly its intent that the phrase was not intended to encompass privately negotiated resale transactions.

The Seventh Circuit in *Pacific Dunlop* relied almost exclusively on the broad definition of "prospectus" in Section 2(10) of the Act to conclude "Section 2(10) is broad enough to include initial and secondary market transactions." 993 F.2d at 588. The court recognized the general rule that a person could not offer or sell a security by means of a prospectus without filing a registration statement and that "[t]his would imply that a prospectus cannot exist without a registration statement." *Id.* at 586. Notwithstanding this plainly proper implication, the court effectively ruled that every sale of securities involves some written or oral communication, so every sale of securities is covered by Section 12(2).

Unlike the Third Circuit, the Seventh Circuit failed to properly analyze the plain meaning of the words used in Section 12(2) particularly in light of the primary purpose of the Act, its structure, and the legislative intent to limit the applicability of Section 12(2) to initial offerings.

The Seventh Circuit failed to consider properly the significant distinction between a prospectus and a stock purchase agreement, a commonly used device for transferring a large block of shares in a privately negotiated transaction. The former is a "single party document"—prepared by the issuer or proponent of the initial offering as a selling device to the public. It is a disclosure and sales tool, prepared without the prospective buyers' input or investigation. The flow of information is one-sided and the incentive to "puff" is great, thereby justifying the protection of, and unique remedy provided by, Section 12(2). In contrast, a stock purchase agreement is a "two-party document"—prepared jointly and negotiated by the buyer and seller. It is not used to solicit the transaction. It merely documents the jointly agreed upon terms of the parties after investigation by the buyer. Such a two-party docu-

ment is not a "prospectus" as referenced in Section 12(2) given the primary objectives of the 1933 Act.

In addressing the legislative history, the Seventh Circuit in *Pacific Dunlop*, 993 F.2d at 589-92, relied primarily on a negative inference from minor revisions in the wording of Section 12(2) and the *lack* of expressed intent as to the scope of the Section in the Senate and Conference Reports, to conclude that secondary market transactions are covered by Section 12(2).

> In the face of the Senate's broad wording, that civil fraud applies to any sale, the commentary by the House's managers remained silent. Although the legislative history in the House report can be read to focus solely on those offerings pursuant to a registration statement and prospectus (or in the Third Circuit's words, to initial offerings), the Senate's version of the 1933 Act and the conference report do not confirm the House's comments.

Id. at 592.

Nor, however, did the Senate's version or Conference Report negate or conflict with the House's comments. As acknowledged by the Seventh Circuit, "[t]he Senate rarely mentioned the word 'prospectus' and certainly not in the fraud context of Section 12(2). And the Senate, as compared to the House, did not draft as detailed a report in support of the bill." *Id.* at 591. Nonetheless, the court relied improperly on general language or silence by the Senate to negate—without really addressing—the explicit House Report, which emphasized that Section 11 and 12 liabilities attached only to untrue statements "in the registration statement or the prospectus—the basic information by which the public is solicited." H.R. Rep. No. 85, 73d Cong., 1st Sess. 9 (1933).

The Seventh Circuit's expansive conclusion that Section 12(2) applies to secondary transactions constitutes an unreasonably broad construction of that Section not warranted by its language, the primary purpose and structure of the Act or the Act's legislative history.

CONCLUSION

The district court below and the Third Circuit in *Ballay* correctly concluded that Section 12(2) does not apply to privately negotiated secondary market transactions that do not resemble an initial offering of securities. The Seventh Circuit's broader interpretation in *Pacific Dunlop* should be rejected. A writ of certiorari should issue to review the judgment of the Court of Appeals for the Seventh Circuit vacating the trial court's judgment in Petitioners' favor.

Respectfully submitted,

GERALD D. SKONING*
HAROLD C. WHEELER
PETER C. WOODFORD
DEBRA A. WINIARSKI
SEYFARTH, SHAW, FAIRWEATHER & GERALDSON
55 East Monroe Street
Suite 4200
Chicago, Illinois 60603
(312) 346-8000

Counsel for Petitioners Daniel R. McLean and Francis I. Butler

DONALD W. JENKINS
THOMAS P. DESMOND
ANDREW M. GARDNER*
MICHAEL L. KAYMAN
VEDDER, PRICE, KAUFMAN & KAMMHOLZ
222 North LaSalle Street
Suite 2600
Chicago, Illinois 60601
(312) 607-7500

Counsel for Petitioner Arthur L. Gustafson

* *Counsel of Record*

APPENDIX

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

June 11, 1993

Before

Hon. WILLIAM J. BAUER, Chief Judge
Hon. FRANK H. EASTERBROOK, Circuit Judge
Hon. MICHAEL S. KANNE, Circuit Judge

ALLOYD COMPANY, INCORPORATED, formerly known as ALLOYD HOLDINGS, INCORPORATED, a Delaware Corporation, and WIND POINT PARTNERS II, L.P., a Delaware Limited Partnership,

Plaintiffs-Appellants,

No. 92-2514 v.

ARTHUR L. GUSTAFSON, DANIEL R. MCLEAN and FRANCIS I. BUTLER,

Defendants-Appellees.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division. No. 91 C 889—Ann Claire Williams, Judge.

This matter comes before the court for its consideration of the following documents:

1. MOTION TO VACATE JUDGMENT AND REMAND TO DISTRICT COURT filed herein on 5/19/93, by counsel for the appellants.

2. DEFENDANTS-APPELLEES' RESPONSE TO PLAINTIFFS-APPELLANTS' MOTION TO VACATE JUDGMENT AND REMAND TO DISTRICT COURT filed herein on 5/28/93, by counsel.

3. PLAINTIFFS-APPELLANTS' MOTION TO FILE REPLY IN SUPPORT OF THEIR MOTION TO VACATE AND REMAND filed herein on 6/2/93, by counsel.

On consideration thereof,

IT IS ORDERED that the Plaintiffs-Appellants' Motion to File Reply in Support of their Motion to Vacate and Remand is DENIED as unnecessary. The judgment of the lower court is VACATED and the this case is REMANDED to the district court for further proceedings in light of this court's opinion in *Pacific Dunlop Holdings, Inc. v. Allen & Co., Inc.*, No. 91-2346 (7th Cir. May 7, 1993).

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

Case No. 91 C 889

ALLOYD CO., INC., et al.,

Plaintiffs,

v.

ARTHUR L. GUSTAFSON, et al.,

Defendants.

MEMORANDUM OPINION AND ORDER

Plaintiffs Alloyd Co., Inc., formerly known as Alloyd Holdings, Inc. ("Holdings") and Wind Point Partners II ("Wind Point") brought this suit against defendants Arthur Gustafson ("Gustafson"), Daniel McLean ("McLean"), and Francis Butler ("Butler"). The plaintiffs claim that the defendants made material misrepresentations when selling all their stock in Alloyd, Inc. ("Alloyd") to them in violation of Section 12(2) of the Securities Exchange Act of 1933 ("Section 12(2)") and in breach of the pertinent stock purchase agreement (the "Agreement"). The parties subsequently brought cross-motions for summary judgment. For the reasons stated below, the court grants defendants' motion for summary judgment and denies plaintiffs' motion as moot.

Background

In 1989, Gustafson, McLean and Butler were the sole shareholders of Alloyd, a manufacturer of clear plastic blister packaging and automatic heat seal packaging equipment. After deciding to sell the company, Alloyd engaged KPMG Peat Marwick ("KPMG") to find a buyer. In the course of soliciting purchasers, KPMG prepared a "profile" describing the company to distribute to parties expressing serious interest in purchasing Alloyd. A copy of this profile was sent to Wind Point.

On August 11, 1989, Wind Point submitted a letter summarizing its interest in Alloyd. Wind Point representatives were then invited to visit Alloyd's physical plant. By October 17, 1989, Alloyd agreed to sell substantially all of its issued and outstanding stock to Holdings, a new corporation to be formed by Wind Point to effectuate the sale of Alloyd. Holdings was subsequently incorporated on November 17, 1989 with McLean and Butler serving as its officers and directors, and Wind Point, McLean, Butler, Carl Lutz, William Lord, and Henry Young as its shareholders.

While negotiating the terms of the Agreement, Wind Point conducted extensive due diligence regarding Alloyd. KPMG also conducted a formal business review of Alloyd and performed other procedures relating to Alloyd's financial statements. KPMG was to report on Alloyd's inventory as well as other aspects of the company's financial performance. Of particular interest to this case, KPMG provided inventory information based upon estimates of the costs of goods sold and gross profits. KPMG could only provide estimates because Alloyd only took inventory at the end of each year. Although the appropriateness of taking a physical inventory was discussed, no physical audit was taken prior to closing on the sale.

At the closing on December 20, 1989, Holdings acquired Alloyd's stock for $18,709,000 plus $2,122,219 to reflect the estimated adjustment amount of Alloyd's earnings. The Agreement signed by Alloyd and Holdings set forth detailed procedures to be followed after the year-end audit was conducted to remit the appropriate amount should the audit disclose a variance between Alloyd's estimated and actual earnings for that year.

By February 8, 1990, McLean determined that Alloyd's actual 1989 earnings and year-end net book value were significantly less than the estimates relied upon to determine Holding's payment of the estimated adjustment amount. This variance was attributed to the fact that Alloyd's year-end inventory was significantly lower than estimated. After confirming the discrepancy, McLean met with Richard Kracum, a general partner of Wind Point and a director of Holdings, and other Wind Point employees to inform them of the shortfall in Alloyd's inventory. On February 11, 1991, the plaintiffs instituted the instant law suit. Pursuant to the adjustment provision in the Agreement, on March 11, 1991, the defendants repaid $815,000 plus interest to Holdings to cover the difference between the estimated adjustment amount paid by Holdings at the closing and the actual adjustment amount due as determined by Alloyd's year-end audit.

The Cross Motions for Summary Judgment

Summary judgment is appropriate when the pleadings and discovery show that "there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56. The moving party bears the initial burden of establishing that no genuine issues of material fact exist. *Celotex Corp.*

v. Catrett, 477 U.S. 317, 321-22 (1986). The nonmoving party must respond to the moving party's claims by establishing specific facts that demonstrate a genuine issue that must be resolved at trial. *Id.* When assessing a motion for summary judgment, the court must accept as true the nonmoving party's evidence and draw all legitimate inferences in the nonmoving party's favor. *Valentine v. Joliet Township High School District*, 802 F.2d 981, 986 (7th Cir. 1986).

In their motion for summary judgment, the defendants raise several procedural arguments which they claim bar the plaintiffs from bringing this law suit. The defendants contend that Wind Point lacks standing to sue under Section 12(2) because it was not a purchaser of the securities at issue. Wind Point counters that it was the actual purchaser of Alloyd because it was the party who negotiated the purchase of Alloyd's stock and created Holdings for the sole purpose of consummating the sale.

Generally, only purchasers have standing to sue for violations of Section 12(2). *Greater Iowa Corp. v. McLendon*, 378 F.2d 783, 789-91 (8th Cir. 1967); *Dyer v. Eastern Trust and Banking Co.*, 336 F. Supp. 890, 910 (D. Me. 1971). Several courts have addressed the question of whether a party who creates a shell corporation to purchase another entity constitutes a purchaser for the purposes of establishing standing. The plaintiffs contend that this court should follow the court's decision in *H.B. Holdings Corp. v. Scovill Inc.* where the court determined that the plaintiff, who had established a shell corporation to purchase the defendant corporation, qualified as a purchaser with standing to sue under Section 12(2). 1990 LW 37869 (S.D. N.Y. March 26, 1990). In *Scovill*, the court noted that the defendant understood that the plaintiff was the purchaser, the defendants had solicited the plaintiff as a purchaser

before the shell corporation was created, the plaintiff submitted the bid that the defendant accepted, and after closing, the plaintiff was in control of the shell corporation. The court concluded that this evidence sufficiently established that the plaintiff was the actual party at risk in the transaction and therefore had standing to sue. *Id.*

This court is persuaded by the court's reasoning in *Scovill*. To hold that plaintiffs who are and were treated by all parties as the actual purchasers do not have standing merely because they did not sign the pertinent sale agreement would be to put form over substance. Although Wind Point did not sign the Agreement in this case, like the plaintiff in *Scovill*, Wind Point was the actual party at risk in the pertinent transaction and was treated as such by all involved parties. For example, before Holdings was created, Wind Point obtained a profile of Alloyd, inspected Alloyd's facilities, and sent a letter of interest to Alloyd. The defendants even acknowledged that in November 1991, they agreed with Wind Point to form a corporation to buy Alloyd. Furthermore, during the course of negotiations over the purchase price, Wind Point conducted due diligence. Then, when the defendants subsequently determined that the inventory estimates they had relied upon to establish a purchase price for Alloyd were inaccurate, they contacted Wind Point employees to inform them of the discrepancy. These facts establish that Wind Point was and the defendants recognized Wind Point as the actual purchaser of Alloyd.

This determination also comports with the Tenth Circuit's decision in *Grubb v. Federal Deposit Insurance Corp.*, 868 F.2d 1151 (10th Cir. 1989). In *Grubb*, the plaintiff and the director of Security National Bank ("SNB") formed a shell corporation to purchase all the shares of SNB from the First National Bank and Trust Company of Oklahoma

City ("First National"). In determining that the plaintiff had standing to sue under the Securities Exchange Act,[1] the court noted that the defendant seller made misrepresentations during direct negotiations with the plaintiff, negotiations occurred before the shell corporation was even established, and the shell corporation was created for the sole purpose of facilitating the purchase. *Id.* at 1161-62. The court also noted that the plaintiff had personally guaranteed the shell corporation's loan to purchase the SNB. *Id.* The *Grubb* court's reliance on the facts that the defendant recognized the plaintiff as the purchaser and the plaintiff was the actual party at risk supports this court's determination that Wind Point has standing in the instant law suit.

The defendants suggest that this court should rely instead upon the court's determination in *Rayman v. Peoples Savings Corp.*, 735 F. Supp. 842 (N.D. Ill. 1990). In *Rayman*, Peoples Savings Corporation ("PSC") created a shell corporation to purchase Peoples Bank of Savings. The Flanagans were principal shareholders of PSC. The question before the court was whether the Flanagans had standing to bring a counterclaim under Section 10(b) of the Securities Act. *Id.* at 844-45. Based upon the court's thorough consideration of the policies underlying Section 10(b), the court determined that it must employ a bright-line definition of a purchaser when determining whether a claimant has standing. *Id.* at 848. Since the court found

[1] The *Grubb* court was faced with the question of whether the plaintiff had standing to sue under Section 10(b) of the Securities Exchange Act. The *Grubb* court's analysis is still applicable to the instant action because the same requirement that the plaintiff be a purchaser of the pertinent stocks arises under Section 10(b) as it does under Section 12(2).

that shareholders do not qualify as purchasers, it held that the Flanagans did not have standing to sue under Section 10(b). *Id.* at 851.

Contrary to the defendants' suggestion, this court declines to follow *Rayman*. This court finds that the *Rayman* court's reliance upon a strict, bright-line definition of a purchaser appears to conflict with the Seventh Circuit's analysis in *Norris v. Wirtz*. 719 F.2d 256 (7th Cir. 1983). In *Norris*, the Seventh Circuit determined that the plaintiff, the beneficiary of a trust which had sold certain stocks, had standing to sue under Section 10(b) and Rule 10b-5 of the Securities Exchange Act. In reaching this conclusion the court stated: "The broad proscription against fraud set forth in Section 10(b) and Rule 10b-5 is defeated in its remedial purposes by taking an unrealistic view of what is alleged to have happened in this case." *Id.* at 260 (citing *Herman & MacLean v. Huddleston*, 103 S.Ct. 683 (1983)). This statement, as well as the court's determination that the plaintiff beneficiary had standing to sue, suggests that the Seventh Circuit did not intend to employ a strict definition of who constitutes a purchaser as the court in *Rayman* suggests.[2]

This court also declines to follow *Rayman* because we are not persuaded that the policy analysis relied upon in *Rayman* court is applicable to the instant law suit. As

[2] The Seventh Circuit also stated that to grant standing to the plaintiff in this case would not threaten the concerns addressed by the standing requirement for Section 10(b) and Rule 10b-5. *Norris*, 719 F.2d at 259. Indeed, in support of this contention, the court cited *James v. Gerber Products Co.* for the proposition that "the courts have generally inclined to a logical and flexible construction of the term 'purchaser-seller' in order to accommodate the avowed purpose of § 10(b) of protecting the investing public and of ensuring honest dealings in securities transactions." *Id.*

previously stated, the *Rayman* court based its determination that a bright-line rule should be employed upon its analysis of the policy considerations underlying Section 10(b). *See* 735 F. Supp. at 848. The defendants in this case have provided this court with no evidence suggesting that the policy concerns underlying Section 10(b) are identical to those under Section 12(2) or are otherwise relevant to this court's determination. Therefore, this court finds that Wind Point has standing to sue under Section 12(2).[3]

The defendants next contend that the plaintiffs' claims are timebarred. Section 13 of the Securities Exchange Act of 1933 requires plaintiffs to bring claims under Section 12(2) within "one year after the discovery of the untrue statement or omission, or after such discovery should have been made by the exercise of reasonable diligence." *DeBruyne v. Equitable Life Assurance Society of the United States*, 920 F.2d 457, 466 (7th Cir. 1990).

[3] The fact that Wind point was not the only shareholder of Holdings also does not affect this court's conclusion that Wind Point has standing to sue under Section 12(2). This court recognizes that the court in *City National Bank of Fort Smith, Arkansas v. Vanderboom* considered the fact that the plaintiffs were not the sole shareholders of the pertinent shell corporation when determining that the plaintiffs did not have standing to sue under Section 10(b). 422 F.2d 221 (8th Cir. 1970). However, this court is not persuaded that the fact that there were several shareholders in Holdings other than Wind Point should prevent Wind Point from establishing standing in the instant case. In this case, Wind Point was the majority shareholder of Holdings and the other shareholders consisted of four of the five key management personnel from Alloyd. *See* Defendants' Statement of Material Facts at ¶¶ 17-18; Defendants' Motion for Summary Judgment at 5. The defendants also acknowledge that they intended to sell Alloyd to Holdings, "a company to be formed by Wind Point." Defendants' Statement of Material Facts at ¶ 15. In addition, unlike in *Vanderboom*, other evidence in this case suggests that Holdings was a conduit formed to purchase Alloyd. *See Id.* at 228.

The parties agree that on February 8, 1990, McLean, now the President of Holdings, became aware of the shortfall in Alloyd's inventory. The parties also agree that McLean did not inform other officers of Holdings of the shortfall until February 12, 1990. The defendants contend that McLean's discovery of the discrepancy on February 8 started the running of the one year limitations period in this case. The plaintiffs counter that the statute of limitations period did not begin to run until February 12 when other Holdings officers learned about the inventory shortfall.

Generally, a principal is charged with the knowledge of its agent acquired in the course of the principal's business. *First National Bank of Cicero v. Lewco Securities Corp.*, 860 F.2d 1407, 1417 (7th Cir. 1988). However, an exception to this rule has been carved out in cases where the agent's interests are shown to be adverse to those of his principal. *Id.* In such cases, it is presumed that such an agent is unlikely to fulfill his fiduciary duty of full disclosure to the principal. *Id.*; Restatement (Second) of Agency § 282(1); *Evanston Bank v. ContiCommodity Services, Inc.*, 623 F. Supp. 1014, 1036 (N.D. Ill. 1985).

Contrary to the defendants' suggestion, even though McLean had become the President of Holdings and Alloyd no longer existed, this court finds that McLean's interests were adverse to those of Holdings. As evidenced by the present case, the inventory shortfall at issue could result in McLean being held liable to Holdings. McLean could therefore have had a personal interest in not telling the other Holding officers about the shortfall. Since McLean's interests were adverse to Holdings, the knowledge he acquired about the shortfall on February 8, 1990 cannot be imputed to Holdings. The statute of limitations period began to run in this case on February 12, 1990, the date

when other Holdings officers learned about the discrepancy. Since the plaintiffs filed their complaint on February 11, 1991, one day before the limitations period ran out, the plaintiffs' Section 12(2) claim is not time-barred as the defendants suggest.

The defendants further contend that the plaintiffs' Section 12(2) claim should be dismissed because this provision can only be applied to initial offerings. Although the case law is divided, the trend favors limiting Section 12(2) actions to purchasers in initial offerings. *See, e.g., Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682 (3d Cir. 1991); *Pacific Dunlop Holdings, Inc. v. Allen & Company Inc.*, 1991 U.S. Dist. LEXIS 6748 (N.D. Ill. 1991); *Bank of Denver v. Southeastern Capital Group, Inc.*, 763 F. Supp. 1552 (D. Co. 1991); *T. Rowe Price New Horizons Fund, Inc. v. Preletz*, 749 F. Supp. 705 (D. Md. 1990); *Grinsell v. Kidder, Peabody, & Co.*, 744 F. Supp. 931 (N.D. Ca. 1990).

This court is persuaded, most notably by the Third Circuit in *Ballay*, that Section 12(2) claims can only arise out of the initial stock offerings. *See* 925 F.2d 682. In a thorough and well-reasoned opinion, the *Ballay* court determined that the language and legislative history of Section 12(2), as well as its relationship to Section 17(a) and 10(b) within the schemes of the 1933 and 1934 Acts, compelled a finding that Section 12(2) only applies to initial offerings and not to after-market trading. *Id.* at 693. The one other court in this district faced with this issue has also agreed with the Third Circuit's analysis. *See Pacific Dunlop Holdings*, 1991 U.S. Dist. LEXIS 6748. Based upon the court's reasoning in *Ballay*, this court therefore concludes that application of Section 12(2) must be restricted to initial distributions.

As the plaintiffs argue, the legislative history of the 1933 Securities Exchange Act suggests that Section 12(2) can be applied to a redistribution of securities if "such redistribution takes on the characteristics of a new offering by reason of the control of the issuer possessed by those responsible for the offering." H.R. No. 85, 73d Cong., 1st Sess. 7 (1933); *Ballay*, 925 F.2d at 690. While the plaintiffs suggest that this language supports their argument that Section 12(2) is applicable, they have provided this court with no evidence to support their claim that the sale at issue possesses the characteristics of a new offering. At most, the plaintiffs claim that the instant case involved the purchase of stock directly from the controlling shareholders rather than from a stockbroker as was the case in *Ballay*. This claim does not suffice to overcome the court's conclusion that Section 12(2) cannot be applied to this case because other evidence more strongly suggests that the transaction at issue in this case cannot be compared to an initial offering. For example, the parties agree that Alloyd was formed in 1961. *See* Defendants' Statement of Material Facts at ¶ 2. Hence, the transaction at issue in this case occurred approximately 30 years after the initial issuance of Alloyd's stock. *See Bank of Denver*, 763 F. Supp. at 1559. Also, unlike purchasers in most initial offerings, the purchasers in this case had direct access to financial and other company documents, and had the opportunity to inspect the seller's property.

Since the plaintiffs fail to provide this court with adequate evidence showing that the pertinent transaction is not comparable to an initial offering, this court finds that Section 12(2) cannot be applied to the instant case. The court therefore grants defendants' motion to dismiss plain-

tiffs' Section 12(2) claim.[4] The court also dismisses plaintiffs' state law breach of contract claim for lack of jurisdiction. Finally, the court denies plaintiffs' motion for summary judgment as moot.

Conclusion

For the reasons stated above, the court grants defendants' motion for summary judgment and denies plaintiffs' motion for summary judgment as moot.

ENTER:

____

Ann Claire Williams, Judge
United States District Court

Dated: May 29, 1992

[4] The defendant also contends that the plaintiffs cannot prove the substantive elements of a Section 12(2) claim. There is no need for this court to consider this argument since, upon review of the defendants' arguments, the court finds that these arguments will not affect our decision to grant defendants' motion for summary judgment because the plaintiffs cannot bring a claim under Section 12(2).

(2)

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No. 93-404

IN THE

Supreme Court Of The United States

OCTOBER TERM, 1993

ARTHUR L. GUSTAFSON,
DANIEL R. McLEAN and
FRANCIS I. BUTLER,

Petitioners,

v.

ALLOYD CO., INC., a Delaware corporation,
f/k/a ALLOYD HOLDINGS, INC., and WIND POINT
PARTNERS II, L.P., a Delaware limited partnership,

Respondents.

Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

---

BRIEF OF RESPONDENTS ALLOYD CO., INC. AND WIND POINT PARTNERS II, L.P. IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI OF ARTHUR L. GUSTAFSON, DANIEL R. McLEAN AND FRANCIS I. BUTLER

Robert J. Kopecky
(Counsel of Record)
Brian D. Sieve
Carole A. Cheney
KIRKLAND & ELLIS
200 East Randolph Drive
Chicago, Illinois 60601
(312) 861-2000
Counsel for Respondents

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QUESTION PRESENTED

Whether section 12(2) of the Securities Act of 1933 applies to material misstatements or omissions in the sale of securities by controlling persons of the issuer.

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Respondents Alloyd Co., Inc. and Wind Point Partners II, L.P. respectfully request that this Court deny the Petition for Writ of Certiorari of Arthur L. Gustafson, Daniel R. McLean and Francis I. Butler.

STATEMENT OF THE CASE

In early 1989, Arthur Gustafson, Daniel McLean, and Francis Butler ("Sellers") decided to solicit bids for the purchase of Alloyd Co., Inc. ("Alloyd").[1] The Sellers were the controlling persons and sole shareholders of Alloyd: Gustafson, Alloyd's President, owned approximately 85% of its stock; McLean, Alloyd's Executive Vice-President, owned approximately 10%; and Butler, Alloyd's Vice-President in charge of marketing, owned approximately 5%.

The Sellers retained KPMG Peat Marwick ("Peat Marwick") to act on their behalf in soliciting bids. In July 1989, Peat Marwick contacted Richard Kracum, a general partner of Wind Point Partners II, L.P. ("Wind Point"), a venture capital partnership that invests in small companies offering unusually high growth potential. Peat Marwick subsequently sent Wind Point a "Profile" describing Alloyd's operating, financial, marketing and other characteristics. In September 1989, Wind Point submitted a written proposal to acquire Alloyd for approximately $41 million. Wind Point calculated the consideration in the proposal based on a multiple of Alloyd's 1989 earnings before interest and taxes ("EBIT"), determined by annualizing the eight-month interim financial figures provided by defendants.

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[1] Respondents state that there are no parent or subsidiary companies to be listed pursuant to Supreme Court Rule 29.1.

On October 17, 1989, the Sellers and Wind Point entered into a Letter Agreement setting forth the terms on which Wind Point would acquire Alloyd. The Letter Agreement specified that Wind Point would form a new corporation -- Alloyd Holdings, Inc. ("Holdings") -- to purchase the common stock of Alloyd.

Shortly thereafter, Wind Point received Alloyd's operating results for the nine months ending September 30, 1989. These financials indicated that Alloyd's 1989 annualized operating income was about $300,000 less than the annualized operating income figure calculated from the earlier financial results provided to Wind Point. Following this disclosure, the parties negotiated a reduction in the purchase price, reflected in a Letter of Amendment executed November 14, 1989.

In October and November 1989, Wind Point representatives had numerous discussions with McLean, whom Gustafson had designated as Sellers' spokesman on financial issues, concerning Alloyd's finances. McLean made numerous representations designed to allay Wind Point's concerns, raised by its advisors, about the reliability of the company's financial information. For example, McLean represented that his cost figures were conservative and that his method of calculating the company's gross profit margin overstated the actual cost of manufacturing (resulting in understatement of the company's earnings and inventory). When Wind Point suggested taking a physical inventory to verify the interim financials, McLean stated that such a step would not be cost-justified because any adjustment to inventory would be small.

On December 20, 1989, the Sellers and Holdings executed a Stock Purchase Agreement ("Purchase Agreement"). The Sellers provided Holdings with Consolidated Interim Financial Statements for the ten-month period ending October 31, 1989. These financials, referred to in section 4D of the Purchase Agreement as the "Latest Balance Sheet," stated that Alloyd had operating income of $3,646,397 and reflected an operating profit margin of 14.2% for the first ten months of 1989.

Because Wind Point had relied on the financial data supplied by the Sellers in determining Alloyd's purchase price, the Purchase Agreement contained representations regarding this information as an inducement to enter into the Agreement. Specifically, the Purchase Agreement represented that all of the financial statements and other financial data provided to the buyers fairly presented Alloyd's true financial condition. Section 4D, for example, warranted that the 1989 interim financial statements "present fairly on a consolidated basis the Company's financial condition and related results of operations." Section 4I warranted that there had been "no material adverse change in or any material adverse event affecting the business, financial condition, operating results, assets, operations or business prospects" of the company between the date of the 1989 interim financial statements and the closing.

The closing occurred on December 22, 1989. At the closing, the Sellers certified that the representations and warranties in the Purchase Agreement were "true and correct in all material respects" as of that date.

On February 12, 1990, Wind Point and Holdings discovered that the information provided by the Sellers had materially misstated Alloyd's 1989 inventory, operating results and profitability. The ten-month interim financial statement provided by the Sellers overstated Alloyd's actual inventory by over $1 million, and overstated its operating income by over 33%, or nearly $1.5 million for the full year 1989. The latter overstatement was particularly significant because Wind Point had based its purchase price on a multiple of Alloyd's 1989 operating income. Wind Point thus paid millions of dollars more than it would have paid had it known Alloyd's true 1989 income.

Alloyd and Wind Point subsequently filed suit against the Sellers in the United States District Court for the Northern District of Illinois, asserting claims for violation of section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77l(2), as well as for breach of contract. Following extensive discovery, the parties filed cross motions for summary judgment. On May 29, 1992, United States District Judge Ann Williams entered an unpublished

Memorandum Opinion and Order granting the Sellers' motion, ruling that section 12(2) does not apply to the transaction between the parties. Judge Williams dismissed the pendent state-law breach of contract claim for lack of subject matter jurisdiction.

Wind Point and Alloyd appealed the summary judgment ruling to the Seventh Circuit Court of Appeals. In an unpublished Order, the Seventh Circuit vacated Judge Williams' May 29, 1992 Order and remanded the case for further proceedings, citing its ruling in Pacific Dunlop Holdings, Inc. v. Allen & Co., 993 F.2d 578 (7th Cir. 1993). The Sellers did not seek a rehearing before the Seventh Circuit, and instead filed a Petition for Certiorari on September 9, 1993.

In the meantime, the parties have refiled their cross motions for summary judgment. Defendants-Petitioners' motion seeks summary judgment on the section 12(2) claim on three separate grounds. Plaintiffs-Respondents filed a cross motion for summary judgment on the breach of contract claim. These motions are fully briefed and awaiting decision by the District Court.

SUMMARY OF ARGUMENT

Because the District Court on remand may decide this case on other legal grounds that would not require this Court to address the question posed in the Petition, the issuance of a writ of certiorari would be premature at the present time. Further, Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d 682 (3d Cir. 1991), cert. denied, --- U.S. ---, 112 S. Ct. 79 (1991), the case cited by the Petitioners to support their claim of a direct conflict among the circuits concerning the applicability of section 12(2) of the Securities Act of 1933 to secondary market transactions, involves brokerage transactions. Ballay does not address the scenario posed in the present case -- i.e., a securities transaction involving the sale of stock by shareholders who control the issuer. The Seventh Circuit correctly decided, based on the plain meaning of the statute and its legislative history, that section 12(2) applies to such postdistribution transactions.

ARGUMENT

I. THE PETITION SHOULD BE DENIED BECAUSE THE ISSUES RAISED COULD BE MOOTED BY THE DISTRICT COURT'S ACTIONS ON REMAND.

The Petitioners seek review of an unpublished, interim opinion in which the Seventh Circuit vacated the judgment of the District Court and remanded for further proceedings in light of the Seventh Circuit's decision in Pacific Dunlop Holdings, Inc. v. Allen & Co., 993 F.2d 578 (7th Cir. 1993). Respondents respectfully suggest that review at this juncture would be premature.

At present there is a fully briefed summary judgment motion that raises other issues pertinent to section 12(2) and which could well moot the issues raised in the Petition for Certiorari. Indeed, that is the precise reason the Seventh Circuit vacated and remanded the case, rather than deciding it on its merits -- because other substantive issues had yet to be considered by the District Court.

The District Court's Order that Alloyd and Wind Point had no claims under section 12(2) was based solely on the ruling that section 12(2) does not apply to secondary transactions. In so holding, the District Court specifically stated that it had not considered certain of the Sellers' other arguments, including the argument that Alloyd and Wind Point could not prove the substantive elements of a section 12(2) claim "since, upon review of the defendants' arguments, the court finds that these arguments will not affect our decision to grant defendants' motion for summary judgment because the plaintiffs cannot bring a claim under Section 12(2)." App. at 14 n.4. If, on remand, the District Court were to determine that the Sellers are not able to prove the substantive elements of a section 12(2) claim or that one of their other legal arguments precludes this claim, there would be no need to address the issues raised in the present petition.

In light of the interlocutory nature of the proceedings, Respondents respectfully suggest that it is too early to determine whether this Court's intervention is necessary to resolve the present dispute.

II. THE PETITION SHOULD BE DENIED BECAUSE THERE IS NO DIRECT CONFLICT AMONG THE CIRCUITS AS TO WHETHER SECTION 12(2) APPLIES TO THE SALE OF SECURITIES BY CONTROLLING SHAREHOLDERS OF THE ISSUER.

The case cited by Petitioners to support their claim of a direct conflict among the circuits -- Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d 682 (3d Cir. 1991), cert. denied, 112 S. Ct. 79 (1991)[2] -- did not decide the applicability of section 12(2) to the sale of securities by shareholders who control the issuer. The Third Circuit addressed the applicability of section 12(2) to a suit against a brokerage firm for alleged misrepresentations in a secondary transaction. In contrast, Pacific Dunlop, on which the Seventh Circuit relied in remanding this case to the District Court, addressed a very different scenario: a transaction in which a plaintiff purchased stock directly from controlling shareholders by means of a purchase agreement.

Indeed, even the Ballay court, in rejecting application of section 12(2) to brokerage transactions, quoted language from the legislative history that supports the application of section 12(2) to sales by shareholders who control the issuer. The Ballay court noted that the 1933 Securities Act "does not affect the ordinary redistribution of securities unless such redistribution takes on the characteristics of a new offering by reason of the control of the issuer possessed by those responsible

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[2] After the Sellers filed their Petition, the Eleventh Circuit followed Ballay in First Union Discount Brokerage Services, Inc. v. Milos, 997 F.2d 835 (11th Cir. 1993), a case also involving brokerage transactions. Milos relied exclusively on the Ballay court's analysis, and, like Ballay, reached the court of appeals after a trial on the merits.

for the offering." Ballay, 925 F.2d at 690 (quoting H. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933) (emphasis added). Because Ballay involved redistribution through a broker, the Third Circuit did not need to decide the extent to which section 12(2) applies to redistributions that take on the characteristics of new offerings because the securities were sold by persons who controlled the issuer.

Thus, Ballay and Pacific Dunlop present two related, but conceptually different, issues. Many of the cases cited by Petitioners to support their claim of a direct conflict among the circuits and which allegedly "favor limiting Section 12(2) to initial distributions," see Petition at 11 & n.1, involve brokerage transactions. Because this case involves a sale of securities directly by controlling stockholders pursuant to a stock purchase agreement, there is no clear conflict between the Third and Seventh Circuits on the issue presented by this case.

III. THE SEVENTH CIRCUIT'S INTERPRETATION OF SECTION 12(2) IS SUPPORTED BY THE PLAIN LANGUAGE OF THE STATUTE AND ITS LEGISLATIVE HISTORY.

The Seventh Circuit's determination that section 12(2) applies to transactions involving the sale of securities by means of written misstatements and omissions by shareholders who control the issuer is amply supported by the language of the statute. Although resort to legislative history is unnecessary, the legislative history also supports the applicability of section 12(2) to transactions involving the sale of stock by controlling shareholders of the issuer.

This Court has repeatedly emphasized that the starting point in construing a statute is the language itself. See Landreth Timber Co. v. Landreth, 471 U.S. 681, 685 (1985); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976). Nothing in the language of section 12(2) limits the provision to initial offerings. Indeed, its language is broad enough to cover any sale of securities, as the Seventh Circuit recognized even prior to its decision in Pacific Dunlop. See Short v. Belleville Shoe Mfg. Co., 908 F.2d 1385, 1390 (7th Cir. 1990) (Easterbrook, J.)(noting that

section 11 deals with errors and omissions in registration statements, section 12(1) deals with sales in violation of section 5, and section 12(2) "addresses all other forms of materially incorrect or misleading selling literature and oral communications in the sale of a security."), cert. denied, --- U.S. ---, 111 S. Ct. 2887 (1991).

Nor does the definition of "prospectus" in section 2(10) of the Act support the narrow interpretation imposed by Ballay and urged by Petitioners. Section 2(10) defines "prospectus" broadly to include "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security . . . ." 15 U.S.C. § 77b(10). Although Petitioners contend that "[t]he Agreement here does not comport with any obvious interpretation of the word 'prospectus,'" Petition at 13, the Seventh Circuit properly rejected this argument in Pacific Dunlop.

As the Seventh Circuit recognized, shortly after enactment of the 1933 Act, the Securities and Exchange Commission acknowledged the breadth of the term "prospectus" in an opinion of its general counsel stating that the term includes within its meaning "every kind of written communication which attempts or offers to dispose of, or solicits an offer to buy, a security for value, or which constitutes a contract of sale or disposition of a security for value." Securities Act Release No. 33-2623 (1941), reprinted in 11 Fed. Reg. 10964 (1946). This opinion was incorporated in substance into the language of section 2(10) through a 1954 statutory amendment. "[T]he congressional reports explicitly referred to the 1941 opinion and stated that the amendment was adopted in order to avoid any implied repeal of 'settled interpretations' of the original text of Section 2(10)." Pacific Dunlop, 993 F.2d at 583.

Further, the context of section 12 does not require that the broad definition of prospectus in section 2(10) be rejected for a more narrow definition of the term in section 12(2). The definitional section 2 of the 1933 Act begins with the phrase "[w]hen used in this title, unless the context otherwise requires . . . ." Although the Act contains more than one

definition of a prospectus,[3] as the Seventh Circuit observed in Pacific Dunlop, "we cannot say that the structure of the 1933 Act, the text of section 12, and in particular the context of the word 'prospectus' in section 12(2), require a definition of prospectus contrary to the broad definition of section 2(10)." 993 F.2d at 588.

Finally, although resort to the legislative history is unnecessary since the "plain language opposes any hint of a limitation to initial distribution," A. Hirsh, Comment, Applying Section 12(2) of the 1933 Securities Act to the Aftermarket, 57 U. Chi. L. Rev. 955, 984 (1990), the legislative history does not require that application of section 12(2) be limited to initial offerings. First, as shown above, even the House Report -- cited in Ballay and by the Petitioners to support the claim that section 12(2) applies only to initial transactions -- contemplates its application to redistribution sales by controlling persons of the issuer. See H. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933). Second, unlike the House, the Senate "proceeded along a different course." Pacific Dunlop, 993 F.2d at 590. The Senate version of the 1933 Act "allowed recovery for fraud in the sale of 'any security,' not just those involved in initial offerings." Id. "Although the Senate did not extensively explain its version, the differing texts display a distinctive treatment on their face." Id. at 591.[4]

[3] For example, Section 10 sets forth what must be included in a statutory prospectus that is part of a registration statement.

[4] The Seventh Circuit correctly rejected an argument that the Senate's final version intended to limit the civil liability provisions to initial offerings. As the Seventh Circuit recognized, "[t]aking for granted (without deciding) that the language of section 12(c) limits the provisions of the Act to initial offerings, the conference report stated that the 'substantially similar [civil liability] provisions of the Senate amendment did not apply to any of the securities exempted under the Senate amendment." Pacific Dunlop, 993 F.2d at 591. Thus, the report "interpreted section 9 of the Senate's version [the Senate version of section 12(2)], which began with the phrase 'Every person acquiring any security,' as language that 'expressly provided' that the limitations of section 12(c) would not have applied." Id. at 591-92.

A House and Senate conference resulted in the final version of the 1933 Act. As the Seventh Circuit recognized, after the conference, "the managers on the part of the House attached a commentary to the final version, addressing the distinctions and the resolution between the previous versions . . . ." Id. Significantly, "[t]he commentary by the House's managers did not mention their version that had limited the application of section 12(2) to fraud in a prospectus or oral communication; rather, the report recognized the Senate version, which applied section 12(2) to the distribution or sale of a security." Id. at 592. The Seventh Circuit observed:

> And there is no legislative history in the Senate that requires the "sale" of a security be limited to initial offerings. In the face of the Senate's broad wording, that civil fraud applies to any sale, the commentary by the House's managers after the joint conference remained silent. Although the legislative history in the House report can be read to focus solely on those offerings pursuant to a registration statement and prospectuses . . . the Senate's version of the 1933 Act and the conference report do not confirm the House's comments.

Id. (emphasis added). When considered in its entirety, the legislative history of section 12(2) supports its application to secondary transactions. Moreover, even the House Report relied on by the Petitioners contemplates application of section 12(2) to redistributions which, because of "control of the issuer possessed by those responsible for the offering," take on the characteristics of new offerings.

The plain language of the statute supports application of section 12(2) to secondary transactions, and, as demonstrated above, the legislative history does not require the contrary. The Seventh Circuit correctly determined that section

12(2) applies to secondary transactions involving the sale of stock by controlling persons -- the factual scenario of the present case.

CONCLUSION

For the foregoing reasons, Alloyd Co., Inc. and Wind Point Partners II, L.P. respectfully request that this Court deny the Petition for Writ of Certiorari of Arthur L. Gustafson, Daniel R. McLean and Francis I. Butler.

Respectfully submitted,

Robert J. Kopecky
(Counsel of Record)
Brian D. Sieve
Carole A. Cheney
KIRKLAND & ELLIS
200 East Randolph Drive
Chicago, Illinois 60601
(312) 861-2000

Counsel for Respondents Alloyd Co., Inc., f/k/a Alloyd Holdings, Inc., and Wind Point Partners II, L.P.

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No. 93-404

In The

Supreme Court of the United States

October Term, 1993

ARTHUR L. GUSTAFSON, DANIEL R. McLEAN and FRANCIS I. BUTLER,

Petitioners,

v.

ALLOYD CO., INC. and WIND POINT PARTNERS II, L.P.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

BRIEF OF *AMICUS CURIAE* SECURITIES INDUSTRY ASSOCIATION, INC. IN SUPPORT OF PETITIONERS

Of Counsel:

STUART J. KASWELL
Sr. Vice Pres. & General Counsel
Securities Industry Association, Inc.
1401 Eye Street NW, Suite 1000
Washington, D.C. 20005
(202) 296-9410

ROBERT L. SCHNELL, JR.*
WENDY J. WILDUNG
JEFFREY D. HEDLUND
SIDNEY J. SPAETH
FAEGRE & BENSON
2200 Norwest Center
90 South Seventh Street
Minneapolis, MN 55402
(612) 336-3000

Attorneys for Amicus Curiae Securities Industry Association, Inc.

*Counsel of Record

May 6, 1994

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

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BRIEF OF *AMICUS CURIAE* SECURITIES INDUSTRY ASSOCIATION, INC. IN SUPPORT OF PETITIONERS

STATEMENT OF INTEREST OF *AMICUS CURIAE*[1]

Securities Industry Association, Inc. ("SIA") is a trade association of approximately 700 securities firms in the United States and Canada that collectively account for approximately 90 percent of the securities business conducted in North America. SIA's members provide a wide variety of professional services to investors and others, including retail and institutional brokerage, over-the-counter market making, underwriting and other investment banking activities, money management and investment advisory services.

The summary order below ordered a remand in light of *Pacific Dunlop Holdings Inc. v. Allen & Co.*, 993 F.2d 578 (7th Cir. 1993), *cert. dismissed*, 114 S. Ct. 1146 (1994). The Seventh Circuit's opinion in *Pacific Dunlop* – which held that Section 12(2) of the Securities Act of 1933 is not limited to initial distributions of securities to the public and determined that liability under that section extended to a private sale of stock – presents a matter of enormous concern to SIA and its members. In light of the relatively modest showing required of a plaintiff under Section 12(2) and the powerful remedy of rescission provided thereunder, this unjustifiably broad interpretation of Section 12(2), if upheld, would impose untenable risks of liability on SIA's members for such ordinary activities as providing investors with research reports containing updated information regarding companies. The *Pacific Dunlop* holding would therefore directly affect the manner in which the members of SIA routinely have done business in the past and would restrict the flow of crucial information to the investing public.

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[1] This brief is filed with the written consent of the parties pursuant to Rule 37.3 of the Rules of this Court. The parties' consent letters have been filed with the Clerk of this Court.

SUMMARY OF ARGUMENT

Congress passed the Securities Act of 1933 (the "1933 Act") to combat perceived abuses in connection with initial distributions of securities to the investing public[2] by mandating the disclosure of detailed information to investors. Section 12(2) was enacted as part of that statutory framework and specifically imposed civil liability on sellers of securities for misrepresentations or omissions in "a prospectus or oral communication." As such, Section 12(2) clearly applies to initial distributions of securities to the investing public. Just as clearly, however, Section 12(2) does *not* apply to secondary market transactions or private sales of securities such as that at issue in the decision below.

The limitation of Section 12(2) to initial distributions of securities is mandated by its plain language, statutory context and legislative history, as well as by critical policy considerations. First, the language of Section 12(2) on its face cannot sensibly be construed to apply to transactions other than initial distributions of securities. Second, when considered as part of the statutory structure established by Congress in the 1933 Act and the Securities Exchange Act of 1934 (the "1934 Act"), it is apparent that the scope of Section 12(2) is limited to initial distributions. Third, the legislative history surrounding the enactment of the 1933 Act reflects Congress's intent to limit the application of Section 12(2) to initial distributions.

Finally, and of particular significance to SIA and its members, critical policy considerations – including the need for the rapid dissemination of information necessary for the efficient operation of capital markets – dictate that Section 12(2) be kept in its rightful place and limited to initial distributions. Imposing the relaxed liability standard and

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[2] The term "initial distribution of securities" is used herein to refer both to initial public offerings and subsequent public offerings by an issuer.

onerous remedies[3] of Section 12(2) on securities firms for their research reports and other post-distribution communications with their customers and other investors will drastically inhibit the flow of information to the investing public. Such a result would be entirely at odds with the goals of the 1933 Congress which sought to provide the investing public with greater access to information regarding securities and the companies that issued them.

This Court should reverse the decision below and hold that the application of Section 12(2) is limited to initial distributions of securities.

ARGUMENT

The central issue in this case is the scope of the term "prospectus" as used in Section 12(2) of the 1933 Act. Section 12(2) imposes civil liability on any seller offering or

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[3] In examining the policy considerations relevant to the interpretation of Section 12(2), this Court should bear in mind that, compared to Section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1988), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1993), Section 12(2) requires a lesser showing of culpability and provides for a broader measure of damages.

A party asserting a claim under Rule 10b-5 is required to establish, among other things, both (i) "scienter" or intent to deceive, manipulate or defraud; and (ii) justifiable reliance upon the alleged misrepresentation or omission. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) ("scienter" requirement); *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988) (reliance requirement). By contrast, Section 12(2) allows recovery for negligent conduct, *Hochfelder*, 425 U.S. at 208, and does not require a showing of reliance by the plaintiff. *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 692 (3d Cir.), *cert. denied*, 112 S.Ct. 79 (1991). Indeed, in stark contrast to Rule 10b-5, Section 12(2) imposes a burden on the defendant of showing that it was not negligent with respect to the alleged misrepresentation or omission.

In addition, Section 12(2) provides for a remedy that is "the substantial equivalent of rescission." *Pinter v. Dahl*, 486 U.S. 622, 641 n.18 (1988). Rule 10b-5, however, permits recovery only of actual damages. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972).

selling a security "by means of a prospectus or oral communication" that contains an untrue statement of material fact or omits to state a necessary material fact. 15 U.S.C. § 77l (1988).[4] Respondents urge an interpretation of "prospectus" which effectively extracts all meaning from the word by interpreting it as any writing relating to the sale of a security. However, a close reading of the language of the 1933 Act, coupled with an analysis of its structure and legislative history, compels a conclusion that "prospectus" refers to writings associated with the public distribution of newly issued securities, a conclusion fully supported by 60 years of efficient functioning of this country's capital markets.

I. THE PLAIN LANGUAGE OF THE 1933 ACT LIMITS THE APPLICATION OF SECTION 12(2) TO INITIAL DISTRIBUTIONS OF SECURITIES.

Congress employed the term "prospectus" in several sections of the 1933 Act. "Prospectus" had a common and well-understood meaning at the time the 1933 Act was enacted, and was frequently used in the congressional debates when the 1933 Act was being considered. 77 Cong. Rec. 2910-55 (1933).[5]

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[4] The text of Section 12(2) is set out in the appendix to this brief.

[5] For example, Rep. Rayburn of Texas, citing the need to impose upon officers of corporations issuing stocks a duty to the purchasers, stated: "The prospectus or advertisement of the security, if it is more than a mere announcement of the name and price of the issue offered, must include any part of the matter contained in the registration statement which the Commission, in its discretion, may require." 77 Cong. Rec. 2918-19 (1933).

Rep. Lambeth of North Carolina stated: "This bill strikes hard at practices which have robbed countless investors of their savings. Interstate and foreign commerce is barred against new securities until registration statements have been on file with the Federal Trade Commission 30 days. At any time thereafter the Commission may issue a 'stop' order for sufficient cause. Every prospectus, by radio or otherwise, must contain the essential parts of the statement." *Id.* at 2948.

See also statements by Rep. Mapes of Michigan at 2912, Rep. Cox at 2920 and 2938, Rep. Parker of New York at 2922 and 2923, Rep. Breedy of

As its Latin root suggests,[6] the term referred to the plan, proposal or "prospects" for a new or expanding enterprise. At the time the 1933 Act was considered, a prospectus was commonly understood to be a document describing a new issue of securities to the public. Contemporary reference works[7] defined a "prospectus" to be:

> A typewritten or printed plan of organization of a new enterprise, or for the expansion of an existing enterprise, usually prepared by the promoters and their associates for the purpose of interesting financiers in the purchase of the securities.

G. Munn, *Encyclopedia of Banking and Finance* at 471 (1924).[8]

Maine at 2953, and Rep. Black of New York at 2954. Reps. Rayburn, Parker and Mapes were all members of the House subcommittee charged with drafting the House bill. Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29, 38 n.16 (1959). Rep. Rayburn chaired both the House Committee on Interstate and Foreign Commerce and the conference committee which reconciled the Senate and House bills. *Id.* at 31, 45.

[6] Prospectus derives from "prospectus," the past participle of the Latin "prospicere," which means to look forward, or exercise foresight. *Webster's Ninth New Collegiate Dictionary* at 945 (1990).

[7] This Court relied on contemporary reference works to construe terms in the 1934 Act in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 198-99 (1976). The Court described this exercise as important to prevent a construction that adds "a gloss to the operative language of the statute quite different from its commonly accepted meaning." *Id.* In construing the terms "manipulative or deceptive" and "device or contrivance" under Section 10(b) of the 1934 Act, the Court relied on *Webster's New Int'l Dictionary of the English Language* (2d ed. 1934).

[8] Other contemporary reference works contained the following definitions of "prospectus":

> A preliminary statement, usually printed, issued by promoters of an enterprise, the publishers of a literary work, the administration of a private school or college, or the like, giving advance information calculated to arouse interest and win support; *specif., an exposition of the conditions of*

Beyond selecting "prospectus" to use throughout the 1933 Act, Congress also used "prospectus" as the first word in the term's own definition. The 1933 Act, as amended, defines "prospectus" as follows:

> any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security . . . .

15 U.S.C. § 77b(10) (1988).[9]

Congress's utilization of prospectus in the word's own definition was not an inadvertent drafting error. Rather, Congress selected this precise term because it had a commonly understood, readily identifiable meaning in connection with the issuance of securities.

Congress's use of the distinct term "prospectus" in the word's own definition also placed the words that immediately follow it into a definitional context. In addition to defining a "prospectus" as a "prospectus," Congress added the specific

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> *incorporation and the financial prospects of a business undertaking.*

Webster's New Int'l Dictionary of the English Language at 1988 (2d ed. 1934) (emphasis added).

> A document published by a company or corporation, or by persons acting as its agents or assignees, setting forth the nature and objects of an issue of shares, debentures, or other securities created by the company or corporation, and inviting the public to subscribe to the issue.

H. Black, *A Law Dictionary* at 959 (2d ed. 1910).

> [T]he name for a notice calling the attention of the public to the issue of any stock or shares, or debentures or other securities. It is generally accompanied by a form of application for the use of persons who are willing to subscribe, and gives particulars as to the amount issued, the security offered, and other matters which intending subscribers may wish to know.

III *Dictionary of Political Economy* at 233 (1918). *See also* III *Palgrave's Dictionary of Political Economy* at 233 (1926).

[9] Among the amendments to the 1933 Act, Congress added the terms "or television" and "or confirms the sale of any security" in 1954. Act of Aug. 10, 1954, ch. 667, Title I, § 3, 68 Stat. 683 (1954).

terms "notice, circular, advertisement, letter, or communication, written or by radio or television." These additional terms were synonymous with or related to "prospectus"[10] and were added to embellish the distinct word prospectus, ensuring that prospectus-like writings did not escape regulation simply because they could be characterized as something else.[11]

The definitional listing in Section 2(10) should be interpreted using traditional rules of statutory construction, which dictate that "words grouped in a list should be given related meaning." *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 207, 218 (1984) (quoting *Third Nat'l Bank v. Impac, Ltd.*, 432 U.S. 312, 322 (1977)).[12]

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[10] The *Encyclopedia of Banking and Finance* notes that a prospectus is issued to the underwriters or financiers, while a "circular" is distributed to the public, "although to some extent, these terms are used synonymously." G. Munn, *Encyclopedia of Banking and Finance* at 471 (1924).

In the House debate on the 1933 Act, Rep. Rayburn referred to "a prospectus or advertisement of the security." 77 Cong. Rec. 2919 (1933). Rep. Lambeth referred to "[e]very prospectus, by radio or otherwise." *Id.* at 2948.

[11] The importance of using such other synonymous terms is exemplified by the registration provisions of the 1933 Act. Section 5(c), 15 U.S.C. § 77e(c) (1988), bars the use of any selling communications prior to the filing of a registration statement. During the time period after the registration has been filed but before it becomes effective (the "waiting period"), Section 5(b)(1), 15 U.S.C. § 77e(b)(1) (1988), bars the use of any "prospectus" to offer or sell a security except a preliminary prospectus meeting the requirements of Section 10, 15 U.S.C. § 77j (1988). The definition in Section 2(10) gives substance to this limitation by ensuring that issuers do not evade this prohibition by using other prospectus-like writings to offer securities for sale. Therefore, by reading Section 2(10) in conjunction with Section 5(b)(1), Congress effectively prohibited the use of written selling materials – except preliminary prospectuses – during the waiting period. *See generally* Weiss, *The Courts Have It Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 Bus. Lawyer 1, 9-12 (1992).

[12] *See also Jarecki v. G.D. Searle & Co.*, 367 U.S. 303, 307 (1961) ("The maxim noscitur a sociis, that a word is known by the company it

This Court used that analytical approach in *Securities Industry Association* to consider whether the acquisition of a retail securities broker by a bank holding company violated Section 20 of the Glass-Steagall Act, 12 U.S.C. § 377 (1988). Section 20 barred member banks from affiliating with entities engaged principally in the "issue, flotation, underwriting, public sale, or distribution" of securities. *Id.* at 216. While the brokerage company undoubtedly was engaged principally in the "public sale" of securities, this Court noted that the words grouped together should be given related meaning, and, therefore, read "public sale" in context with the underwriting activity described by the terms elsewhere in the list to conclude that the acquisition did not violate Section 20. *Id.* at 218, 221.

Similarly, the terms following "prospectus" in Section 2(10) must be read in light of the terms with which they are associated. Specifically, the words in Section 2(10) must be read as referring not to *any* "communication," for example, but to a specific type of communication. This communication – identified and given context by the word prospectus – refers to the written transmission of information offering an issue of securities to the public.

The Seventh Circuit in *Pacific Dunlop*, 993 F.2d at 588, read the Section 2(10) definition of "prospectus" as referring to *any* written communication. As a result, *any* document connected with the sale of a security qualifies as a "prospectus". Such a myopic reading, focusing on one or two words of the definition to the exclusion of the remainder, should be rejected because it ignores the remaining definitional language in Section 2(10). After all, reciting a list of defined terms and then concluding the list with the catchall of "other communication" is pointless unless the terms are read in light of one another and in light of the point that is being made. The full context of the definition of "prospectus"

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keeps, while not an inescapable rule, is often wisely applied where a word is capable of many meanings in order to avoid the giving of unintended breadth to the Acts of Congress.").

shows that Congress had in mind writings associated with the public sale of new issues.

Moreover, the interpretation of the *Pacific Dunlop* court ignores the "by means of a prospectus or oral communication" language of Section 12(2). Congress specifically used the term "prospectus or oral communication" in Section 12(2) as a limitation. Even the *Pacific Dunlop* court concedes that "oral communication" in Section 12(2) refers not to any oral communication but only to an oral communication made in connection with a written prospectus. *Pacific Dunlop*, 993 F.2d at 588. *See also Ballay*, 925 F.2d at 688. Yet, defining "prospectus" as any communication reads out any limiting language used by Congress by making any written or oral communication actionable. If Congress had intended *any* oral or written communication to be actionable under Section 12(2), it could directly have used the more appropriate language "any written or oral communication" or even more concisely "any communication" in Section 12(2). *See Reves v. Ernst & Young*, 113 S. Ct. 1163, 1169 (1993) (explaining that Congress's definitions should not be read so as to make words superfluous.)

II. THE STATUTORY CONTEXT OF SECTION 12(2) LIMITS ITS APPLICATION TO INITIAL DISTRIBUTIONS OF SECURITIES.

The structure of the 1933 Act indicates Congress's intent to restrict Section 12(2) to initial offerings of securities to the public. Section 12(2) follows Sections 11 and 12(1), and immediately precedes Section 13. Section 11 imposes civil liability for false statements in registration statements and Section 12(1) imposes civil liability for the sale of unregistered securities – violations that arise in the course of initial offerings. Section 13 establishes the statute of limitations for civil actions brought under Sections 11 and 12. *See Ballay*, 925 F.2d at 691.

Section 12(2) rounds out this initial distribution civil liability scheme by imposing liability in connection with misstatements made pursuant to a prospectus or related oral communication. Thus, the provisions of Sections 11, 12(1)

and 12(2) together cover the universe of possibilities in an initial distribution – failure to register, misstatements or omissions in registration, and misstatements or omissions in public offerings.

Section 12(2)'s placement in conjunction with Section 12(1) is particularly telling. Section 12(1) unambiguously concerns only initial distributions of securities. Had Congress intended a broader scope for Section 12(2), it would wisely have established Section 12(2) as a completely separate provision or, at a minimum, explained Section 12(2)'s wider applicability. *See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 62 U.S.L.W. 4230, 4233 (U.S. April 19, 1994) (explaining that "Congress knew how to impose . . . liability when it chose to do so.")

Yet, the *Pacific Dunlop* interpretation creates the oddity of finding a broad remedy under Section 12(2) in the midst of a closely woven pattern of regulatory sections concerned exclusively with the initial offerings of securities. This interpretation is particularly puzzling in light of the fact that there is no indication anywhere that Congress intended Section 12(2) to have broader applicability than the surrounding provisions of Sections 11, 12(1) and 13.

On the other hand, Congress specifically did so indicate when it created a broad remedial provision in Section 17, 15 U.S.C. § 77q (1988), which provides criminal penalties and other governmental enforcement mechanisms for both initial and secondary market transactions. *See United States v. Naftalin*, 441 U.S. 768, 777-78 (1979). The language of Sections 17 and 12(2), while similar in some respects, differs markedly on the essential point of liability. Section 12(2) limits liability to communications made "by means of a prospectus or oral communication." Section 17, conversely, imposes liability for conduct "directly or indirectly" that "employ[s] any device" to defraud, or to obtain money through "any untrue statement" or "any omission."[13] The language of Section 17 has no limitation corresponding to that found in Section 12(2).

[13] The text of Section 17 is set out in the appendix to this brief.

Sections 17 and 12(2) have distinct purposes – government enforcement versus private causes of action. Sections 17 and 12(2) have distinct language – broad versus narrow. And Sections 17 and 12(2) have distinct standards of culpability – fraud versus negligence. As such, it is disingenuous to argue that Congress intended these two sections to have identical applications.

Moreover, the Court has recognized Congress's intent that Section 17 be unique. As noted by this Court in *Naftalin*:

> Although it is true that the 1933 Act was primarily concerned with the regulation of new offerings, respondent's argument fails because the antifraud prohibition of § 17(a) was meant as a major departure from that limitation. Unlike much of the rest of the Act, it was intended to cover any fraudulent scheme in an offer or sale of securities, whether in the course of an initial distribution or in the course of ordinary secondary market trading.

Naftalin, 441 U.S. at 777-78. This Court's conclusion was based upon the legislative history of Section 17, including the Senate report, which provided:

> The act subjects the sale of *old or outstanding securities* to the same criminal penalties and injunctive authority for fraud, deception, or misrepresentation *as in the case of new issues put out after the approval of the act*. In other words, fraud or deception in the sale of securities may be prosecuted *regardless of whether the security is old or new*, or whether or not it is of the class of securities exempted under sections 11 or 12.

Id. at 778 (quoting S. Rep. No. 47, 73d Cong., 1st Sess., 4 (1933) (emphasis added)). No corresponding "major departure" from the 1933 Act's focus on initial distributions is found with respect to Section 12(2) in the language, context or legislative history of the 1933 Act.

The 1933 Act must also be read in light of the subsequent regulatory scheme put in place under the 1934 Act. The 1934 Act was principally intended to protect investors against

manipulation of publicly traded securities by regulating transactions on securities exchanges, and to impose regular reporting requirements on companies whose stock is listed on the exchanges. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976). The extensive disclosure requirements of the 1934 Act implemented a philosophy of "full disclosure." *Basic Inc. v. Levinson*, 485 U.S. 224, 230 (1988).

The rules of the Securities and Exchange Commission (the "SEC"), in total, provide an array of reporting requirements to keep investors current on the financial status of companies whose securities trade publicly.[14] In view of the purpose of the 1934 Act and its stringent reporting requirements, it is discordant, at best, to suggest that Congress placed a broad remedial remedy for post-registration misstatements or omissions in the 1933 Act, while it did not impose the post-registration disclosure requirements until the 1934 Act.

Finally, several unique characteristics of Section 12(2) are only explainable by an interpretation restricting that section to initial distributions. First, the remedies under Section 12(2) apply only to buyers. If Congress's intent was to combat all negligent misrepresentations in both initial distributions and secondary market transactions, it logically would have applied Section 12(2) to both buyers and sellers, as it did with Section 10 of the 1934 Act. Recognizing Congress's understanding and intent that Section 12(2) would be limited to initial distributions, however, explains why its remedies were applied only to buyers. A buyer in an initial distribution of securities is in no position to make misstatements of fact to the sellers, so any remedies granted to sellers under Section 12(2) would be superfluous.

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[14] The 1934 Act authorized the SEC to issue rules delineating these reporting requirements. 15 U.S.C. § 78m. Among the reports required to be filed are an annual Form 10-K report, a quarterly Form 10-Q report, and Form 8-K report with respect to certain specified events. *See* SEC Rule 13a, 17 C.F.R. Ch. 2 §§ 13a-1 *et seq.* (1993).

Second, the rescissionary measure of damages under Section 12(2) is an equitable remedy only when sellers are engaged in an initial distribution. In an initial distribution, the seller receives the full consideration paid by the buyer and the rescissionary measure of damages makes sense as an appropriate remedy. In secondary market transactions, a "seller" such as a broker or other professional advisor may receive only a relatively small fee for its services. *Ballay*, 925 F.2d at 693. It would be unjustifiably punitive to force such a seller – who never receives the consideration in the first place – to pay back a rescissionary measure of damages for a negligently made error.

Third, the rescissionary measure of damages and the limiting of remedies to buyers make sense only in the context of initial distributions because those distributions are one-party agreements. That is, the issuer and its underwriters formulate the terms of the sale and the issuer provides all the information that the public will receive in the prospectus. *See Ballay*, 925 F.2d at 693. A private stock purchase agreement – like the contract at issue in this case – is a two-party agreement. Both sides to the agreement negotiate the terms of the agreement, the information provided therein, and the warranties and other allocations of risk within the sale. It would be anomalous to provide a remedy exclusively to one party to such a two-sided transaction.

III. THE LEGISLATIVE HISTORY OF THE 1933 ACT DEMONSTRATES CONGRESS'S INTENT TO RESTRICT SECTION 12(2) TO INITIAL DISTRIBUTIONS OF SECURITIES.

The 1933 Act primarily was concerned with the regulation of new public offerings of securities. *See Central Bank of Denver, N.A.*, 62 U.S.L.W. at 4232 ("The 1933 Act regulates initial distributions of securities . . . . "); *United States v. Naftalin*, 441 U.S. 768, 778-79 (1979). As Congress considered the 1933 Act, it was well known that a separate act would be forthcoming to regulate secondary market transactions. Abrams, *The Scope of Liability Under Section 12 of the Securities Act of 1933: "Participation" and the Pertinent*

Legislative Materials, 15 Fordham Urb. L.J. 877, 906 (1987). While the scope of the 1933 Act is not limited exclusively to initial offerings, "[n]othing in the legislative history or structure of the 1933 Act indicates that Congress intended to broaden section 12(2) beyond the 1933 Act's principal purpose of regulating the distribution of new offerings." *Ballay*, 925 F.2d at 690.

President Franklin D. Roosevelt urged Congress on March 29, 1933, to create a mechanism to provide the investing public with full information regarding newly issued securities.[15] Both houses of Congress responded with bills that would regulate the issuance of new securities to the public. The House bill, which provided the framework of the 1933 Act, specifically limited the application of Section 12(2) to initial distributions.[16] In its general analysis of the entire bill, the House Report said:

> The bill affects only new offerings of securities sold through the use of the mails or of instrumentalities of interstate or foreign transportation or communication. It does not affect the ordinary redistribution of securities unless such redistribution takes on the characteristics of a new offering by reason of the control of the issue possessed by those responsible for the offering.

H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933).

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[15] President Roosevelt stated:

> There is, however, an obligation upon us to insist that *every issue of new securities to be sold in interstate commerce* shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933) (emphasis added).

[16] James M. Landis, a key drafter of the House bill, described the draft bill as follows: "Throughout, [the bill's] patent concern was primarily with the flow of securities from the issuer through underwriters to the public rather than with the subsequent buying and selling of these securities by the public." Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29, 36 (1959).

In specifically addressing the civil liability provisions of the bill, the House Report explained that Sections 11 and 12 "entitle the buyer of securities sold upon a registration statement" to sue for recovery of the purchase price. *Id.* at 9. Specifically, the report noted:

> The committee emphasizes that these liabilities attach only when there has been an untrue statement of material fact or an omission to state a material fact in the registration statement or the prospectus – *the basic information by which the public is solicited.*

Id. (emphasis added).

The House Report explained the provisions of Sections 11 and 12 in some detail. The report noted that placing the burden of proving an exemption from liability on a seller was indispensable with respect to a registration statement or prospectus because "[e]very lawyer knows that with all the facts in the control of the defendant it is practically impossible for a buyer to prove a state of knowledge or a failure to exercise due care on the part of defendant." *Id.*

The report explained that the elimination of the reliance requirement under Sections 11 and 12 was appropriate because the statements made in initial offerings would have wide dissemination and, consequently, would affect the price of the security:

> The statements for which they are responsible, although they may never have been seen by the prospective purchaser, because of their wide dissemination, determine the market price of the security.

Id. at 10.

The Members who debated the 1933 Act in the House recognized that the 1933 Act would impose civil liability under Section 12(2) only in connection with new issues of securities to the public. Rep. Sabath of Illinois lamented the fact that the House bill did not prevent manipulative transactions in the secondary market. "I had hoped that we would enact a bill at this time that would forever prevent dishonest listings transactions. But unfortunately the committee came to

the conclusion that at this time they could not do it all in one bill." 77 Cong. Rec. 2915 (1933).

Rep. Smith of Washington echoed these sentiments:

> I am in hearty accord with this measure. It will be a forward stride and will protect the American public and buyers of securities. However, it will not reach evils from which the American people have suffered in recent years and from which they are still suffering.
>
> The manipulation of securities after they have been issued embraces and constitutes a greater evil than those arising from the original issue of securities.

Id. at 2941. Finally, Rep. Lambeth of North Carolina said that "while just now we cannot safely deal with securities already before the public nor with corporate management in reference to the investor, there will be another story before long." *Id.* at 2948. *See also id.* at 2919 (stocks already listed on exchanges are not affected by the bill) (remarks of Rep. Rayburn of Texas); *id.* at 2924 (open-market transactions on the exchanges are exempted) (remarks of Rep. Bulwinkle of North Carolina); and *id.* at 2939 (federal authority lapses when the security reaches its "destination, and becomes intermingled in the common mass of property.") (remarks of Rep. Cox of Georgia).

The Senate bill likewise exclusively targeted the initial distribution of securities to the public. The Senate bill contained specific exclusions for "securities which have been issued and are outstanding in the hands of the public prior to the date of the approval of the act" [except securities valued at more than $100,000], and for "isolated transactions." S. Rep. No. 47, 73d Congress, 1st Sess. 4 (1933).

The Senate Report emphasized that these exempted outstanding securities would nevertheless be subject to the criminal penalties and injunctive authority that were eventually framed in Section 17 of the 1933 Act. *Id.* at 4. The Senate bill did not provide that civil remedies under Sections 11 and 12 similarly would be available for existing securities.

After Senate Bill 875 had passed and was in the Conference Committee, Sen. Norbeck of South Dakota explained the

bill's exclusive focus on initial public offerings and its inapplicability to fraud in the secondary market. In discussing the Senate bill, Sen. Norbeck stated that the Senate Committee on Banking and Currency continued to investigate improper conduct in the stock exchanges, but stated: "The pending bill does not in any way deal with the stock exchange. That matter has been left for subsequent and much-needed legislation." 77 Cong. Rec. 3223 (1933).[17]

The conference committee report prepared by the managers for the House detailed the differences between the Senate and House bills and the ultimate resolution of those disputes. The report does not indicate any dispute as to limiting the civil remedies of Section 12 to the public sale of new issues. H.R. Rep. No. 152, 73d Cong., 1st Sess. (1933).[18]

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[17] Sen. Norbeck explained that the Senate bill had three "high points":

> First. That a sworn statement must be filed with the Federal Trade Commission before securities can be offered for sale, and substantial penalties are connected with any violation of the act.
>
> Second. This legislation goes farther than to prevent misrepresentations; it makes it mandatory that the whole truth be told in a signed statement and also in advertisements or any publicity in connection with the sale of securities. It recognizes the fact that a half truth is a falsehood. This will be a new thing in American corporation law; it is i fact copied after the British law.
>
> Third. The directors, underwriters, and issuing houses of the corporation provided for are personally responsible for misrepresentation and may have to answer in court for such misrepresentation.

77 Cong. Rec. 3223 (1933).

[18] Common sense would suggest that if the conference committee had made such a fundamental change as extending Section 12(2)'s civil liability provisions to secondary market transactions, it would have so indicated. As this Court has often noted, Congress's silence in a context such as this is a "dog that did not bark." *See Chisom v. Roemer*, 501 U.S. 380, 111 S. Ct. 2354, 2364 (1991) (quoting Arthur Conan Doyle, *Silver*

Therefore, both the House and Senate bills recognized that Section 12 of the 1933 Act would be limited to new offerings. This understanding is further reflected in the fact that the Senate bill's exclusions for outstanding securities and isolated trades were not included in the 1933 Act. Since there is no indication anywhere that the Senate disagreed with the House bill's restriction of Section 12(2) to newly issued securities, the only explanation for the removal of these exceptions is that they were deemed moot.

IV. CRITICAL POLICY CONSIDERATIONS REQUIRE THAT THE APPLICATION OF SECTION 12(2) BE LIMITED TO INITIAL DISTRIBUTIONS OF SECURITIES.

This Court has repeatedly "acknowledged that 'it is proper for a court to consider . . . policy considerations in construing terms in [the federal securities] Acts.'" *Pinter v. Dahl*, 486 U.S. 622, 653 (1988) (quoting *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 694 n.7 (1985)). Important policy considerations – including, most significantly, the need for efficient securities markets in which prices reflect all available information regarding securities – dictate that the application of Section 12(2) should be limited to initial distributions of securities.

A. The Application of Section 12(2) to Secondary Market Transactions Will Discourage the Communication of Market Research to the Investing Public.

The potentially devastating impact of applying Section 12(2) to trading in the secondary market is illustrated by contrasting the preparation and role of registration statements for the issuance of securities with the reports prepared by securities analysts after such securities are issued and trading.

Blaze, The Complete Sherlock Holmes 335 (1927)). *See also Church of Scientology v. IRS*, 484 U.S. 9, 17-18 (1987).

Parties involved in the initial distribution of securities to the public routinely engage in an exhaustive "due diligence" process.[19] For example, underwriters of securities (which include many of SIA's members) ordinarily conduct a wide-ranging investigation of the company and its business, including interviewing company officials, contacting customers, inspecting the company's physical operations and working closely with underwriter's counsel and the company's auditors.[20] After the investigation has been completed, the process "may entail numerous drafting sessions at which top management, issuer's counsel, and the investment banker's personnel and counsel meticulously review the registration statement line by line for style, for content, and for compliance with applicable disclosure requirements." 1 H. Bloomenthal, *Going Public and the Public Corporation* § 1.03, at 1-9 to 1-10 (1993). The costs arising from this lengthy and expensive due diligence process are incurred as part of the cost of obtaining access to public capital markets.[21]

This extensive due diligence process is undertaken, in substantial part, because initial distributions of securities are issued to the public by means of a prospectus and therefore clearly subject to Section 12(2). Any party that could be construed to be a "seller" of the securities issued – and therefore potentially liable under Section 12(2) – will necessarily conduct such due diligence in order to establish later, if

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[19] This process typically involves, at a minimum, participation by the company's management, the company's legal counsel, the managing underwriters, the underwriters' legal counsel and the company's independent public accountants, each of which has a separate role in investigating the company and the accuracy of the prospectus. *See* Sonsini, Taylor & Husick, *Who Does What in a Securities Registration*, The Practical Lawyer, vol. 39, no. 8, at 44 (Dec. 1993).

[20] *See* Sonsini, Taylor & Husick, *supra*, at 64-65 (listing 21 steps in due diligence process engaged in by underwriters in two reported cases).

[21] One commentator estimates that out-of-pocket expenses typically incurred in the registration process "are likely to be not less than $250,000 and may be in excess of $1 million . . . . " 1 H. Bloomenthal, *supra*, § 1.03, at 1-9.

necessary, that it met its duty of reasonable care under Section 12(2) to discover any misrepresentations or omissions in the prospectus. The intensity and length of the investigation are a result of the stringent liability standard applied.

By contrast, the process by which securities analysts associated with many of SIA's member firms prepare research reports on publicly traded companies is strikingly different from the registration process described above.[22] Analysts attempt to "ferret out what there is to know about a company from its published information, from what is known about the industry, and what [they] can learn from the company." 1B H. Bloomenthal, *supra*, § 13.11[2], at 13-43 (1993 ed.). As the SEC noted in *In re Dirks*, securities firms use this information in advising their existing or potential clients with respect to the purchase or sale of particular securities.

Unlike the lengthy, exhaustive and expensive registration process, however, the preparation of research reports is necessarily far less detailed and much more rapid. Analysts often prepare reports with partial information regarding the companies they follow. Although analysts can request information from company representatives, company officials have no obligation to provide any information to the analysts, unlike the registration process where management is effectively

[22] The SEC has described the role of such analysts as follows:

> [Securities analysts] are in the business of formulating opinions and insights – not obvious to the general investing public – concerning the attractiveness of particular securities. In the course of their work, analysts actively seek out bits and pieces of corporate information not generally known to the market for the express purpose of analyzing that information and informing their clients who, in turn, can be expected to trade on the basis of the information conveyed.

In re Dirks, Exchange Act Release No. 17480, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,812, at 83,945 (1981) (footnote omitted), *aff'd*, *Dirks v. SEC*, 681 F.2d 824 (D.C. Cir. 1982), *rev'd on other grounds*, 463 U.S. 646 (1983).

required to assist in any due diligence investigation.[23] In fact, the registration process constitutes the only comprehensive "snapshot" of a company's condition at a single point in time that most companies ever experience. By contrast, analysts discover incremental bits of information regarding a company over time which evolve into a series of ever-changing research reports.

The sheer number of companies whose securities are publicly traded also necessarily limits the resources to which analysts can devote to any single company.[24] Moreover, in order to provide their customers with the most current information available regarding such companies, analysts typically prepare and issue their reports immediately after discovering any significant information regarding the company.

[23] In connection with a public offering, the management of a company has an enormous incentive to cooperate with a due diligence investigation because the company's ability to obtain the desired financing is contingent upon the completion of such an investigation. After the initial distribution of the company's securities, however, management may have an incentive *not* to assist analysts with their requests for information. Some courts have analogized an encounter between a corporate executive and an analyst to a "fencing match conducted on a tightrope." *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 9 (2d Cir. 1977). The dissemination of such research may result in inappropriate comment on the company, *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165 (2d Cir. 1980), may reduce the price of the company's stock or, in extreme cases such as that in *Dirks*, reveal fraudulent activities by management. *See Dirks*, 463 U.S. at 658 n.18 (describing corporate fraud uncovered by securities analyst).

[24] In 1992, over 2,000 companies were listed on the New York Stock Exchange, over 800 companies were listed on the American Stock Exchange, and over 4,000 companies were listed on NASDAQ. Securities Industry Association, *1993 Securities Industry Fact Book* at 23 (G. Toto & G. Monahan eds. 1993); *The Business One Irwin Investor's Handbook* at 78 (1993); *1993 Nasdaq Fact Book & Company Directory* (1993). The value of outstanding corporate equities in 1992 exceeded $5 trillion, of which almost $4.8 trillion was listed on the New York Stock Exchange, the American Stock Exchange and NASDAQ. *1993 Securities Industry Fact Book*, *supra*, at 21, 23.

Neither the 1933 Act nor the 1934 Act has created a serious statutory impediment to the issuance of such research reports in a prompt fashion and without complete access to corporate information because such reports are recognized as being subject to a "scienter" standard of liability under Rule 10b-5, rather than subject to a negligence standard of liability under Section 12(2). Of course, securities firms have understood that they will be liable under Rule 10b-5 for any misrepresentation or omission in their research reports that is the product of "intent to deceive, manipulate, or defraud," *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976), but that is a league apart from being subject to a negligence standard under which the steps they did or did not take in researching a company would be second-guessed after the fact.[25] Under that statutory framework, securities firms have followed many companies and frequently issued reports on such companies in an expeditious fashion for their customers.

This practice is threatened by a likely "chilling effect" of the rule of law adopted in the decision below. If the term "prospectus" in Section 12(2) is construed to include virtually all written communications, including research reports, securities firms will be extremely circumspect in issuing such reports in the future given their potential liability under Section 12(2) and the burden of defending such claims.[26] It is not hard to imagine that purchasers of securities could claim that

[25] Under the scienter standard of Rule 10b-5, it is well-established that one cannot show scienter simply by second-guessing a previously made statement with the benefit of "20-20 hindsight" through, what several courts have called, "Monday morning quarterbacking." *See, e.g. In re Donald J. Trump Casino Sec. Litig.*, 793 F. Supp. 543, 556 (D.N.J. 1992), *aff'd*, 7 F.3d 357 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994); *In re Apple Computer Sec. Litig.*, 672 F. Supp. 1552, 1564 (N.D. Cal. 1987), *aff'd in part and rev'd in part*, 886 F.2d 1109 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990). By contrast, the essence of any negligence standard of liability is an analysis in hindsight of a party's actions.

[26] *Cf. New York Times Co. v. Sullivan*, 376 U.S. 254, 279 (1964) (holding that placing burden of establishing truth of contested statements on libel defendants causes "self-censorship" of truthful speech because

a research report contained a material misrepresentation or omission, which under Section 12(2) would impose the burden on the securities firm of showing that it "did not know, and in the exercise of reasonable care could not have known" of the misrepresentation or omission.

In order to ensure that they will be able to establish a Section 12(2) defense, securities firms would be required, if possible, to investigate every conceivable fact regarding a company in a fashion much like the process currently undertaken with respect to registration statements and prospectuses.[27] As a practical matter, such an investigation may not be possible since the company's management is under no obligation to provide information in response to an analyst's inquiries and may actually have an incentive not to cooperate with analysts.

Moreover, research reports issued subject to Section 12(2) would not be issued as promptly as they currently are. If such reports were subject to Section 12(2), their issuance would be delayed while a registration-like "line-by-line" review was undertaken. The communication of important new

speakers will be deterred from speaking by risk of liability and burden of defending such claims). *New York Times Co* requires public official libel plaintiffs to establish "actual malice" – that is, that the speaker acted with "knowledge that [the statement] was false or with reckless disregard of whether it was false or not" – which serves a gatekeeper function with respect to such actions and promotes the flow of information to the public. *Id.* at 279-80. Applying the intent-based "scienter" requirement of Rule 10b-5 to research reports – rather than the negligence standard of Section 12(2) – also serves as a gatekeeper with respect to claims by investors and, similarly, promotes the flow of information to the marketplace.

[27] Ironically, such a rule would impose a higher burden of investigation with respect to research reports issued by securities firms than that currently imposed by Congress and the SEC on publicly traded companies with respect to their annual and quarterly reports and other public filings. *See* Section 18 of the 1934 Act, 15 U.S.C. § 78r (1988).

information about companies to the investing public would thus be delayed, if not precluded.[28]

Given the enormous potential liability under Section 12(2) that would arise from even an innocently made error, securities firms would have to weigh that considerable risk in deciding whether to issue such reports at all. For many such firms and for many issuers,[29] the risk would likely outweigh the benefit of such reports for securities firms in meeting the needs of their customers for information and advice.[30] The result would likely be less complete and less current information for investors, and less access to capital markets for new companies.

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[28] Indeed, if research reports were subject to Section 12(2), a securities firm could even be liable for a typographical error negligently made in a report, as illustrated in *Ballay*, 925 F.2d 682. *Ballay* involved, among other things, a claim that a research report mistakenly stated that the value for a company's stock *excluded* goodwill, when the value in fact *included* goodwill. 925 F.2d at 686. In the absence of an intent to deceive, manipulate or defraud, the securities firm would have had no liability under Rule 10b-5 for such a negligent mistake, as the jury in fact determined in *Ballay*. *Id.* Under Section 12(2), however, the firm could be subject to rescissionary damages with respect to a secondary market transaction in which it received, at most, a commission for particular isolated sales. Because Section 12(2) does not require a showing of either reliance or causation, the firm could be liable not only to purchasers who in fact relied upon the language containing the typographical error, but also to purchasers who never even saw that report.

[29] It is likely that smaller capitalized companies – which have relatively fewer shareholders and less trading in their shares – would be the first to lose research coverage under such a regime since there will generally be less demand for research regarding them.

[30] *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 n.33 (1976) (Establishing a negligence standard under Rule 10b-5 would raise "serious policy questions not yet addressed by Congress.")

B. A Decline in the Communication of Market Research to the Investing Public Will Interfere with the Efficient Operation of Capital Markets.

Securities markets thrive on information. This Court has acknowledged that Congress relied upon this fundamental premise in enacting the federal securities laws and has noted that "empirical studies have tended to confirm Congress's premise that the market price of shares traded on well-developed markets reflects all publicly available information . . . . " *Basic Inc. v. Levinson*, 485 U.S. 224, 246 (1988).

Because they increase the amount of publicly available information regarding companies, securities analysts play a crucial role in the efficient operation of the market for securities.[31] In view of this important function played by analysts, the SEC has expressed concerns about "discourag[ing] analysts from engaging in the legitimate and desirable function of seeking out corporate information." *In re Dirks*, Exchange Act Release No. 17480, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,812, at 83,947 (1981), *aff'd*, *Dirks v. SEC*, 681 F.2d 824 (D.C. Cir. 1982), *rev'd on other grounds*, 463 U.S. 646 (1983).

This Court – in commenting upon the role the research analyst played in uncovering fraud in *Dirks* – also recognized the important role that analysts play in "the preservation of a healthy market." *Dirks*, 463 U.S. at 658. Although analysts do not routinely discover widespread fraud by corporations, their research indisputably brings more complete information to the trading market, which allows market prices to reflect that

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[31] As the SEC itself has explained:

> The value to the entire market of these efforts [by securities analysts] cannot be gainsaid; market efficiency in pricing is significantly enhanced by such initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors.

In re Dirks, Exchange Act Release No. 17480, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,812, at 83,945 (1981) (footnote omitted), *aff'd*, *Dirks v. SEC*, 681 F.2d 824 (D.C. Cir. 1982), *rev'd on other grounds*, 463 U.S. 646 (1983).

information, and draws capital into the market by allowing investors to trade with confidence that their judgment is based on solid information.[32]

As discussed above, the application of Section 12(2) to securities analysts' research reports will reduce the availability and timeliness of such reports to the investing public, thus impeding the efficient operation of capital markets. As a policy matter, Section 12(2) should not be interpreted to produce that result.

C. Policy Considerations Dictate that Section 12(2) Not Be Applied to Privately Negotiated Sales of Securities.

Important policy considerations also counsel against applying Section 12(2) to privately negotiated sales of stock, such as the transaction at issue in the case below.[33] Treating a privately negotiated stock purchase agreement as a "prospectus" for purposes of Section 12(2) would impose an amorphous federal negligence standard on the due diligence investigation undertaken for such transactions, a matter that is currently subject to negotiation between the parties. Such a mandatory federal standard would require the seller, and the

[32] The SEC and the exchanges have long encouraged corporations to hold meetings with analysts in order to serve the important function of collecting, evaluating and disseminating corporate information for public use. *Elkind, supra*, 635 F.2d at 165. Commentators have also recognized the importance of independent corporate research to the proper functioning of the capital markets. *See, e.g.*, Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 Harv. L. Rev. 322, 341 (1979); Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities and Exchange Commission*, 13 Hofstra L. Rev. 127, 130 (1984).

[33] Privately negotiated stock transactions typically involve sophisticated parties who are in a position to bargain for the protections desired. A purchaser in such a transaction will undertake extensive due diligence and commonly will base its decisions entirely on its own evaluation of the business. Fishman, *Duty to Disclose Under Rule 10b-5 in Face-to-Face Transactions*, 12 J. Corp. L. 251, 256-57 (1987).

seller's agents, to investigate every aspect of the business, even when the buyer has no interest whatsoever in the result of that investigation or would prefer to undertake the investigation itself. As such, the application of Section 12(2) to such a transaction would simply increase transaction costs by imposing a "deadweight" loss on the parties.

The stock purchase at issue in the decision below is an example of such a transaction.[34] Respondents, with the assistance of professional advisers, negotiated to acquire stock from petitioners pursuant to an extensively negotiated stock purchase agreement. In the agreement, the parties carefully delineated the representations and warranties made by the sellers. The transaction closed only after respondents had an opportunity to conduct a due diligence investigation with complete access to the company's books and records, employees and physical facilities. *Gustafson v. Alloyd Co., Inc.*, Petition for Writ of Certiorari at 4-7.

The decision below – which remanded in light of the *Pacific Dunlop* determination that a privately negotiated stock purchase agreement is a "prospectus" within the meaning of Section 12(2) – reallocates the burden of investigation in an inefficient fashion. The parties' arms-length agreement provided specific representations, warranties and limitations of remedies and granted respondents complete access to the company's books and records to conduct their own investigation. If respondents desired further representations and warranties from the sellers regarding the business of the company, they could have negotiated for such contractual protection by offering additional consideration to petitioners.

[34] Respondents assert that Section 12(2) should be applied to their purchase of the stock of Alloyd Co., Inc., because the stock purchase took on the characteristics of a new offering of securities to the public. *Gustafson v. Alloyd Co., Inc.*, No. 93-404, Brief of Respondents In Opposition to Petition for a Writ of Certiorari at 8. Respondents' stock purchase had none of the attributes of an initial distribution of securities to the public. In order to take on the characteristics of an initial distribution of securities to the public, a secondary market transaction, at a minimum, would require an offering of the security to the public.

Presumably for sound economic reasons, they chose not to do so.

Applying Section 12(2) to such a transaction between sophisticated parties bargaining at arms-length imposes a mandatory federal standard that supersedes the parties' ability to allocate contractually the duty of investigation.[35] If sellers in such transactions face potential Section 12(2) liability, they effectively will be required to engage in a due diligence investigation of the company so that they may later show that "in the exercise of reasonable care [they] could not have known" of any misrepresentations or omissions. This is so even if the purchaser prefers to conduct its own due diligence rather than rely on the seller's representations. Requiring a seller to bear that burden will increase transaction costs unnecessarily. Weiss, *The Courts Have it Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 Bus. Lawyer 1, 32 (1992).

Indeed, the application of Section 12(2) to privately negotiated stock purchase agreements would likely lead to investigations by sellers and their agents with respect to matters that are of no interest to buyers.[36] The inefficiency of such a rule of law is evident on its face.[37] Without such a mandatory federal standard, the parties are able to investigate, and negotiate for representations with respect to, only the aspects of the business that are truly of interest to the buyer.

[35] The parties could not agree contractually that Section 12(2) would not apply to the transaction. 15 U.S.C. § 77n (1988).

[36] For instance, a purchaser may be concerned about only a portion of the acquired corporation's business or operations and may attempt to obtain protection, in the form of contractual representations and warranties, on only this aspect of the business. Fishman, *Duty to Disclose Under Rule 10b-5 in Face-to-Face Transactions*, 12 J. Corp. L. 251, 257 n.38 (1987).

[37] *See* Fishman, *supra*, 12 J. Corp. L. at 323 (concluding that placing duty of disclosure on seller in a privately negotiated stock transaction inefficiently increases transaction costs insofar as it requires an investigation of aspects of the business by the seller that is not valued by either party).

Application of Section 12(2) to such private transactions thus would increase the costs of transactions and disrupt the delicate balance of privately negotiated agreements. Balanced against this burden is the fact that truly defrauded parties have a more than adequate remedy under Rule 10b-5 if the other party to the transaction in fact acted with intent to deceive, manipulate or defraud. Given that adequate legal protection already exists for truly defrauded parties,[38] policy considerations dictate that Section 12(2) not be applied to privately negotiated stock transactions when such a liability rule simply would increase the costs of transactions and limit the ability of parties to reach binding private agreements regarding the burden of investigation and risk.[39]

[38] Of course, injured parties may also have state common law remedies. Here, respondents asserted a claim for breach of the stock purchase agreement.

[39] Justice Stevens generally recognized these policy considerations in *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 700 (1985) (Stevens, J., dissenting) ("There is no suggestion that the buyers were unable to obtain appropriate warranties or to insist on the exchange and independent evaluation of relevant financial information before entering into the transactions."). In *Landreth*, the Court relied upon "the plain meaning" of the definition of "security" in Section 2(1) of the 1933 Act in holding that stock transferred pursuant to a private stock purchase agreement fell within that definition. *Id.* at 687. In this case, by contrast, the plain meaning of the definition of "prospectus" in Section 2(10) does *not* encompass private stock purchase agreements, *see* § I *supra*, and thus the policy rationale recognized by Justice Stevens should apply with full force in this context. Here, the plain meaning of "prospectus" is fully supportive of the result that sound policy also dictates.

CONCLUSION

For the foregoing reasons, SIA respectfully requests that the Court reverse the decision below and hold that liability under Section 12(2) of the Securities Act of 1933 is limited to initial distributions of securities to the public.

Respectfully submitted,

Of Counsel:

STUART J. KASWELL
Sr. Vice Pres. &
General Counsel
Securities Industry
Association, Inc.
1401 Eye Street NW,
Suite 1000
Washington, D.C. 20005
(202) 296-9410

ROBERT L. SCHNELL, JR.*
WENDY J. WILDUNG
JEFFREY D. HEDLUND
SIDNEY J. SPAETH
FAEGRE & BENSON
2200 Norwest Center
90 South Seventh Street
Minneapolis, MN 55402
(612) 336-3000

Attorneys for Amicus Curiae Securities Industry Association, Inc.

*Counsel of Record

May 6, 1994

APPENDIX

Section 12(2) of the 1933 Act, 15 U.S.C. § 771 (1988):

Any person who –

* * *

(2) offers or sells a security (whether or not exempted by the provisions of section 77c [section 3] of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Section 17 of the 1933 Act, 15 U.S.C. § 77q (1988):

(a) It shall be unlawfull for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly –

(1) to employ any device, scheme or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

(b) It shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicly to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

(c) The exemptions provided in section 77c of this title shall not apply to the provisions of this section.

(4)

No. 93-404

In The

Supreme Court of the United States

October Term, 1993

ARTHUR L. GUSTAFSON, DANIEL R. McLEAN AND FRANCIS I. BUTLER,

Petitioners,

v.

ALLOYD CO., INC. AND WIND POINT PARTNERS, II, L.P.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

JOINT APPENDIX

DONALD W. JENKINS*
THOMAS P. DESMOND
JENNIFER R. EVANS

VEDDER, PRICE, KAUFMAN & KAMMHOLZ
222 North LaSalle Street
Chicago, IL 60601
(312) 609-7500

Counsel for Petitioner Arthur L. Gustafson

* Counsel of Record

HAROLD C. WHEELER*
PETER C. WOODFORD
DEBRA A. WINIARSKI

SEYFARTH, SHAW, FAIRWEATHER & GERALDSON
55 East Monroe Street
Chicago, IL 60603
(312) 346-8000

Counsel for Petitioners Daniel R. McLean and Francis I. Butler

* Counsel of Record

ROBERT J. KOPECKY*
BRIAN D. SIEVE
CAROLE A. CHENEY

KIRKLAND & ELLIS
200 East Randolph Drive
Chicago, IL 60601
(312) 861-2000

Counsel for Respondents

* Counsel of Record

Petition For Certiorari Filed September 9, 1993
Certiorari Granted March 7, 1994

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3/20/91	19	AMENDED COMPLAINT [1-1] by plaintiff; jury demand
3/22/91	8	ANSWER TO FIRST AMENDED COMPLAINT by defendant Arthur L Gustafson
3/26/91	14	ANSWER to first amended complaint by defendant Daniel R McLean, defendant Francis I Butler; jury demand
10/22/91	51	Document Sealed (pursuant to Court Order) Motion by defendants for summary judgment and rule 12(m) statement of undisputed facts (cmf)
10/31/91	58	Document Sealed (pursuant to Court Order of 07/09/91). Memorandum by defendants in support of motion for summary judgment.
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5/29/92	74	MINUTE ORDER of 5/29/92 by Hon. Ann C. Williams : Pursuant to memorandum opinion and order, the court grants defendants motion for summary judgment and denies plaintiffs' motion for summary judgment as moot. Memorandum opinion and order entered under seal.
6/25/92	76	NOTICE OF APPEAL by plaintiff Alloyd Company Inc and plaintiff Wind Point Partners II, L.P. from motion minute order
6/25/92	77	JURISDICTIONAL STATEMENT by plaintiff Alloyd Company Inc, and plaintiff Wind Point Partners II, L.P. regarding appeal
3/24/94		REPORT AND RECOMMENDATION of Hon. Joan H. Lefkow: Both plaintiffs' and defendants' motion for summary judgment be denied.

U.S. COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

6/29/92	Private civil case docketed. [92-2514]
6/29/92	Filed Appellant Alloyd Company, Appellant Wind Point jurisdictional statement.
7/7/92	Added attorney Michelle H. Browdy per appearance form for Appellant Alloyd Company, Appellant Wind Point.
7/7/92	Appearance form filed for Appellant Alloyd Company, Appellant Wind Point by attorneys Michelle H. Browdy, Robert J. Kopecky and Brian D. Sieve.
7/7/92	Filed "MOTION TO HOLD BRIEFING IN ABEYANCE PENDING THIS COURT'S DECISION IN ANOTHER PENDING CASE" by Appellant Alloyd Company, Appellant Wind Point.
7/8/92	ORDER: Filed clerk's notice to Arthur L. Gustafson, Daniel R. McLean and Francis I. Butler to file 0&3 copies of response to MOTION TO HOLD BRIEFING IN ABEYANCE PENDING THIS COURT'S DECISION IN ANOTHER PENDING CASE.
7/9/92	Orig. record on appeal filed. Contents of record: 1 vol. pleadings; 1 vol. transcripts; 3 envelopes filed IN CAMERA.
7/9/92	Appearance form filed for Appellee Daniel R. McLean and Francis I. Butler by attorney Debra A. Winiarski, Peter C. Woodford, Harold C. Wheeler.
7/9/92	Added attorney Michael L. Kayman per appearance form for Appellee Arthur L. Gustafson.

7/9/92	Appearance form filed for Appellee Arthur L. Gustafson by attorney Michael K Kayman, Sheryl A. Kuzma, Donald W. Jenkins.
7/14/92	Filed Appellee Arthur L. Gustafson, Appellee Daniel R. McLean, Appellee Francis I. Butler response to Appellant Alloyd Company, Appellant Wind Point motion to hold the briefing schedule IN ABEYANCE.
7/16/92	Supp. record on appeal filed.
7/16/92	ORDER issued GRANTING motion to abate case and this appeal is HELD IN ABEYANCE pending the court's decision in Pacific Dunlop Holdings, Inc. v. Allen & Company, Inc. and Daniel Heffernan, No. 91-2346, set for oral argument on 9/11/92. Counsel shall file a status report within 10 days of the court's decision in Pacific Dunlop or on 11/16/92, whichever date earlier occurs.
7/28/92	Filed "AGREED MOTION TO UNSEAL DOCUMENTS" by Appellee Francis I. Butler, Appellee Daniel R. McLean, Appellee Arthur L. Gustafson, Appellant Wind Point, Appellant Alloyd Company.
7/30/92	ORDER issued GRANTING "AGREED MOTION TO UNSEAL DOCUMENTS".
8/12/92	Filed Seventh Circuit Transcript Information Sheet by Brian D. Sieve for Appellant Alloyd Company, Appellant Wind Point.
11/16/92	Filed status report by Appellant Wind Point, Appellant Alloyd Company.

11/17/92	ORDER re: Status report of 11/16/92. Counsel for Appellant Wind Point, Appellant Alloyd Company are ordered to file a further status report.
1/4/93	Filed status report by Appellee Francis I. Butler, Appellee Daniel R. McLean, Appellee Arthur L. Gustafson, Appellant Wind Point, Appellant Alloyd Company.
4/30/93	ORDER re: Status report of 1/4/93. Counsel for Appellee Francis I. Butler, Appellee Daniel R. McLean, Appellee Arthur L. Gustafson, Appellant Wind Point, Appellant Alloyd Company are ordered to file a further status report.
5/19/93	Filed motion by Appellant Wind Point, Appellant Alloyd Company to remand case [493637-1] and, to vacate the district court's judgment.
5/20/93	ORDER: Filed clerk's notice to Francis I. Butler, Daniel R. McLean, Arthur L. Gustafson to file 0&3 copies of response to "MOTION TO VACATE JUDGMENT AND REMAND TO THE DISTRICT COURT" filed herein on 5/19/93, by counsel for the appellants.
5/28/93	Filed Appellee Francis I. Butler, Appellee Daniel R. McLean, Appellee Arthur L. Gustafson response to Appellant Wind Point, Appellant Alloyd Company motion to vacate judgment and to remand case to district court.
6/2/93	Filed motion by Appellant Wind Point, Appellant Alloyd Company to file reply in support of their motion to vacate and remand.

6/3/93	Filed status report by Appellee Francis I. Butler, Appellee Daniel R. McLean, Appellee Arthur L. Gustafson, Appellant Wind Point, Appellant Alloyd Company.
6/11/93	ORDER issued DENYING plaintiff-appellants' Motion to File Reply in Support of their Motion to Vacate and Remand as unnecessary. The judgment of the lower court is vacated and the case is REMANDED to the district court for further proceedings in light of this court's opinion in Dunlap Holdings, Inc. v. Allen & Co., No. 91-2346 (7th Cir. May 7, 1993).
6/30/93	MANDATE ISSUED AND ENTIRE RECORD RETURNED.
7/1/93	Filed motion by Appellee Francis I. Butler, Appellee Daniel R. McLean, Appellee Arthur L. Gustafson to recall and stay the mandate.
7/7/93	Filed Appellant Wind Point, Appellant Alloyd Company opposition to Appellee Francis I. Butler, Appellee Daniel R. McLean, Appellee Arthur L. Gustafson motion for recall and stay of mandate.
7/8/93	ORDER issued DENYING motion to recall and stay of mandate.
7/9/93	ORDER re: Opposition to Motion for Recall and Stay of Mandate filed 7/7/93 by counsel for the appellants. On 7/8/93, this court denied appellee's motion to recall and stay the mandate. Accordingly, IT IS ORDERED that the Opposition to Motion for Recall and Stay of Mandate will be filed without further court action.

9/20/93	Filed notice from the United States Supreme Court of the filing of a Petition for Writ of Certiorari.
3/14/94	Filed order from the United States Supreme Court GRANTING Petition for Writ of Certiorari.

UNITED STATES COURT OF APPEALS

For the Seventh Circuit
Chicago, Illinois 60604

June 11, 1993

Before
Hon. WILLIAM J. BAUER, Chief Judge
Hon. FRANK H. EASTERBROOK, Circuit Judge
Hon. MICHAEL S. KANNE, Circuit Judge

ALLOYD COMPANY, INCORPORATED, formerly known as ALLOYD HOLDINGS, INCORPORATED, a Delaware Corporation and WIND POINT PARTNERS II, L.P., a Delaware Limited Partnership, Plaintiffs-Appellants,	Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.
No. 92-2514 v.	No. 91 C 889
ARTHUR L. GUSTAFSON, DANIEL R. MCLEAN and FRANCIS I. BUTLER, Defendants-Appellees.	Ann Claire Williams, Judge.

This matter comes before the court for its consideration of the following documents:

1. **MOTION TO VACATE JUDGMENT AND REMAND TO DISTRICT COURT** filed herein on 5/19/93, by counsel for the appellants.

2. **DEFENDANTS-APPELLEES' RESPONSE TO PLAINTIFFS-APPELLANTS' MOTION TO VACATE JUDGMENT AND REMAND TO DISTRICT COURT** filed herein on 5/28/93, by counsel.

3. **PLAINTIFFS-APPELLANTS' MOTION TO FILE REPLY IN SUPPORT OF THEIR MOTION TO VACATE AND REMAND** filed herein on 6/2/93, by counsel.

On consideration thereof,

IT IS ORDERED that the Plaintiffs-Appellants' Motion to File Reply in Support of their Motion to Vacate and Remand is **DENIED** as unnecessary. The judgment of the lower court is **VACATED** and this case is **REMANDED** to the district court for further proceedings in light of this court's opinion in *Pacific Dunlop Holdings, Inc. v. Allen & Co., Inc.*, No. 91-2346 (7th Cir. May 7, 1993).

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

ALLOYD CO., INC., et al.,	)	
Plaintiffs,	)	
	)	Case No.
v.	)	91 C 889
ARTHUR L. GUSTAFSON, et al.,	)	
	)	
Defendants.	)	

MEMORANDUM OPINION AND ORDER

Plaintiffs Alloyd Co., Inc., formerly known as Alloyd Holdings, Inc. ("Holdings") and Wind Point Partners II ("Wind Point") brought this suit against defendants Arthur Gustafson ("Gustafson"), Daniel McLean ("McLean"), and Francis Butler ("Butler"). The plaintiffs claim that the defendants made material misrepresentations when selling all their stock in Alloyd, Inc. ("Alloyd") to them in violation of Section 12(2) of the Securities Exchange Act of 1933 ("Section 12(2)") and in breach of the pertinent stock purchase agreement (the "Agreement"). The parties subsequently brought cross-motions for summary judgment. For the reasons stated below, the court grants defendants' motion for summary judgment and denies plaintiffs' motion as moot.

Background

In 1989, Gustafson, McLean and Butler were the sole shareholders of Alloyd, a manufacturer of clear plastic blister packaging and automatic heat seal packaging equipment. After deciding to sell the company, Alloyd

engaged KPMG Peat Marwick ("KPMG") to find a buyer. In the course of soliciting purchasers, KPMG prepared a "profile" describing the company to distribute to parties expressing serious interest in purchasing Alloyd. A copy of this profile was sent to Wind Point.

On August 11, 1989, Wind Point submitted a letter summarizing its interest in Alloyd. Wind Point representatives were then invited to visit Alloyd's physical plant. By October 17, 1989, Alloyd agreed to sell substantially all of its issued and outstanding stock to Holdings, a new corporation to be formed by Wind Point to effectuate the sale of Alloyd. Holdings was subsequently incorporated on November 17, 1989 with McLean and Butler serving as its officers and directors, and Wind Point, McLean, Butler, Carl Lutz, William Lord, and Henry Young as its shareholders.

While negotiating the terms of the Agreement, Wind Point conducted extensive due diligence regarding Alloyd. KPMG also conducted a formal business review of Alloyd and performed other procedures relating to Alloyd's financial statements. KPMG was to report on Alloyd's inventory as well as other aspects of the company's financial performance. Of particular interest to this case, KPMG provided inventory information based upon estimates of the costs of goods sold and gross profits. KPMG could only provide estimates because Alloyd only took inventory at the end of each year. Although the appropriateness of taking a physical inventory was discussed, no physical audit was taken prior to closing on the sale.

At the closing on December 20, 1989, Holdings acquired Alloyd's stock for $18,709,000 plus $2,122,219 to reflect the estimated adjustment amount of Alloyd's earnings. The Agreement signed by Alloyd and Holdings set forth detailed procedures to be followed after the year-end audit was conducted to remit the appropriate amount should the audit disclose a variance between Alloyd's estimated and actual earnings for that year.

By February 8, 1990, McLean determined that Alloyd's actual 1989 earnings and year-end net book value were significantly less than the estimates relied upon to determine Holding's payment of the estimated adjustment amount. This variance was attributed to the fact that Alloyd's year-end inventory was significantly lower than estimated. After confirming the discrepancy, McLean met with Richard Kracum, a general partner of Wind Point and a director of Holdings, and other Wind Point employees to inform them of the shortfall in Alloyd's inventory. On February 11, 1991, the plaintiffs instituted the instant law suit. Pursuant to the adjustment provision in the Agreement, on March 11, 1991, the defendants repaid $815,000 plus interest to Holdings to cover the difference between the estimated adjustment amount paid by Holdings at the closing and the actual adjustment amount due as determined by Alloyd's year-end audit.

The Cross Motions for Summary Judgment

Summary judgment is appropriate when the pleadings and discovery show that "there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P.

56. The moving party bears the initial burden of establishing that no genuine issues of material fact exist. *Celotex Corp v. Catrett*, 477 U.S. 317, 321-22 (1986). The nonmoving party must respond to the moving party's claims by establishing specific facts that demonstrate a genuine issue that must be resolved at trial. *Id.* When assessing a motion for summary judgment, the court must accept as true the nonmoving party's evidence and draw all legitimate inferences in the nonmoving party's favor. *Valentine v. Joliet Township High School District*, 802 F.2d 981, 986 (7th Cir. 1986).

In their motion for summary judgment, the defendants raise several procedural arguments which they claim bar the plaintiffs from bringing this law suit. The defendants contend that Wind Point lacks standing to sue under Section 12(2) because it was not a purchaser of the securities at issue. Wind Point counters that it was the actual purchaser of Alloyd because it was the party who negotiated the purchase of Alloyd's stock and created Holdings for the sole purpose of consummating the sale.

Generally, only purchasers have standing to sue for violations of Section 12(2). *Greater Iowa Corp. v. McLendon*, 378 F.2d 783, 789-91 (8th Cir. 1967); *Dyer v. Eastern Trust and Banking Co.*, 336 F. Supp. 890, 910 (D. Me. 1971). Several courts have addressed the question of whether a party who creates a shell corporation to purchase another entity constitutes a purchaser for the purposes of establishing standing. The plaintiffs contend that this court should follow the court's decision in *H.B. Holdings Corp. v. Scovill Inc.* where the court determined that the plaintiff, who had established a shell corporation to purchase the defendant corporation, qualified as a purchaser with

standing to sue under Section 12(2). 1990 LW 37869 (S.D.N.Y. March 26, 1990). In *Scovill*, the court noted that the defendant understood that the plaintiff was the purchaser, the defendants had solicited the plaintiff as a purchaser before the shell corporation was created, the plaintiff submitted the bid that the defendant accepted, and after closing, the plaintiff was in control of the shell corporation. The court concluded that this evidence sufficiently established that the plaintiff was the actual party at risk in the transaction and therefore had standing to sue. *Id.*

This court is persuaded by the court's reasoning in *Scovill*. To hold that plaintiffs who are and were treated by all parties as the actual purchasers do not have standing merely because they did not sign the pertinent sale agreement would be to put form over substance. Although Wind Point did not sign the Agreement in this case, like the plaintiff in *Scovill*, Wind Point was the actual party at risk in the pertinent transaction and was treated as such by all involved parties. For example, before Holdings was created, Wind Point obtained a profile of Alloyd, inspected Alloyd's facilities, and sent a letter of interest to Alloyd. The defendants even acknowledged that in November 1991, they agreed with Wind Point to form a corporation to buy Alloyd. Furthermore, during the course of negotiations over the purchase price, Wind Point conducted due diligence. Then, when the defendants subsequently determined that the inventory estimates they had relied upon to establish a purchase price for Alloyd were inaccurate, they contacted Wind Point employees to inform them of the discrepancy. These

facts establish that Wind Point was and the defendants recognized Wind Point as the actual purchaser of Alloyd.

This determination also comports with the Tenth Circuit's decision in *Grubb v. Federal Deposit Insurance Corp.*, 868 F.2d 1151 10th Cir. 1989). In *Grubb*, the plaintiff and the director of Security National Bank ("SNB") formed a shell corporation to purchase all the shares of SNB from the First National Bank and Trust Company of Oklahoma City ("First National"). In determining that the plaintiff had standing to sue under the Securities Exchange Act,[1] the court noted that the defendant seller made misrepresentations during direct negotiations with the plaintiff, negotiations occurred before the shell corporation was even established, and the shell corporation was created for the sole purpose of facilitating the purchase. *Id.* at 1161-62. The court also noted that the plaintiff had personally guaranteed the shell corporation's loan to purchase the SNB. *Id.* The *Grubb* court's reliance on the facts that the defendant recognized the plaintiff as the purchaser and the plaintiff was the actual party at risk supports this court's determination that Wind Point has standing in the instant law suit.

The defendants suggest that this court should rely instead upon the court's determination in *Rayman v. Peoples Savings Corp.*, 735 F. Supp. 842 (N.D. Ill. 1990). In

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[1] The *Grubb* court was faced with the question of whether the plaintiff had standing to sue under Section 10(b) of the Securities Exchange Act. The *Grubb* court's analysis is still applicable to the instant action because the same requirement that the plaintiff be a purchaser of the pertinent stocks arises under Section 10(b) as it does under Section 12(2).

Rayman, Peoples Savings Corporation ("PSC") created a shell corporation to purchase Peoples Bank of Savings. The Flanagans were principal shareholders of PSC. The question before the court was whether the Flanagans had standing to bring a counterclaim under Section 10(b) of the Securities Act. *Id.* at 844-45. Based upon the court's thorough consideration of the policies underlying Section 10(b), the court determined that it must employ a bright-line definition of a purchaser when determining whether a claimant has standing. *Id.* at 848. Since the court found that shareholders do not qualify as purchasers, it held that the Flanagans did not have standing to sue under Section 10(b). *Id.* at 851.

Contrary to the defendants' suggestion, this court declines to follow *Rayman*. This court finds that the *Rayman* court's reliance upon a strict, bright-line definition of a purchaser appears to conflict with the Seventh Circuit's analysis in *Norris v. Wirtz*. 719 F.2d 256 (7th Cir. 1983). In *Norris*, the Seventh Circuit determined that the plaintiff, the beneficiary of a trust which had sold certain stocks, had standing to sue under Section 10(b) and Rule 10b-5 of the Securities Exchange Act. In reaching this conclusion the court stated: "The broad proscription against fraud set forth in Section 10(b) and Rule 10b-5 is defeated in its remedial purposes by taking an unrealistic view of what is alleged to have happened in this case." *Id.* at 260 (citing *Herman & MacLean v. Huddleston*, 103 S.Ct. 683 (1983)). This statement, as well as the court's determination that the plaintiff beneficiary had standing to sue, suggests that the Seventh Circuit did not intend to employ a strict

definition of who constitutes a purchaser as the court in *Rayman* suggests.[2]

This court also declines to follow *Rayman* because we are not persuaded that the policy analysis relied upon in *Rayman* court is applicable to the instant law suit. As previously stated, the *Rayman* court based its determination that a bright-line rule should be employed upon its analysis of the policy considerations underlying Section 10(b). *See* 735 F. Supp. at 848. The defendants in this case have provided this court with no evidence suggesting that the policy concerns underlying Section 10(b) are identical to those under Section 12(2) or are otherwise relevant to this court's determination. Therefore, this court finds that Wind Point has standing to sue under Section 12(2).[3]

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[2] The Seventh Circuit also stated that to grant standing to the plaintiff in this case would not threaten the concerns addressed by the standing requirement for Section 10(b) and Rule 10b-5. *Norris*, 719 F.2d at 259. Indeed, in support of this contention, the court cited *James v. Gerber Products Co.* for the proposition that "the courts have generally inclined to a logical and flexible construction of the term 'purchaser-seller' in order to accommodate the avowed purpose of § 10(b) of protecting the investing public and of ensuring honest dealings in securities transactions." *Id.*

[3] The fact that Wind Point was not the only shareholder of Holdings also does not affect this court's conclusion that Wind Point has standing to sue under Section 12(2). This court recognizes that the court in *City National Bank of Fort Smith, Arkansas v. Vanderboom* considered the fact that the plaintiffs were not the sole shareholders of the pertinent shell corporation when determining that the plaintiffs did not have standing to sue under Section 10(b). 422 F.2d 221 (8th Cir. 1970). However, this court is not persuaded that the fact that there were several shareholders

The defendants next contend that the plaintiffs' claims are timebarred. Section 13 of the Securities Exchange Act of 1933 requires plaintiffs to bring claims under Section 12(2) within "one year after the discovery of the untrue statement or omission, or after such discovery should have been made by the exercise of reasonable diligence." *DeBruyne v. Equitable Life Assurance Society of the United States*, 920 F.2d 457, 466 (7th Cir. 1990).

The parties agree that on February 8, 1990, McLean, now the President of Holdings, became aware of the shortfall in Alloyd's inventory. The parties also agree that McLean did not inform other officers of Holdings of the shortfall until February 12, 1990. The defendants contend that McLean's discovery of the discrepancy on February 8 started the running of the one year limitations period in this case. The plaintiffs counter that the statute of limitations period did not begin to run until February 12 when other Holdings officers learned about the inventory shortfall.

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in Holdings other than Wind Point should prevent Wind Point from establishing standing in the instant case. In this case, Wind Point was the majority shareholder of Holdings and the other shareholders consisted of four of the five key management personnel from Alloyd. *See* Defendants' Statement of Material Facts at ¶¶ 17-18; Defendants' Motion for Summary Judgment at 5. The defendants also acknowledge that they intended to sell Alloyd to Holdings, "a company to be formed by Wind Point." Defendants' Statement of Material Facts at ¶ 15. In addition, unlike in *Vanderboom*, other evidence in this case suggests that Holdings was a conduit formed to purchase Alloyd. *See Id.* at 228.

Generally, a principal is charged with the knowledge of its agent acquired in the course of the principal's business. *First National Bank of Cicero v. Lewco Securities Corp.*, 860 F.2d 1407, 1417 (7th Cir. 1988). However, an exception to this rule has been carved out in cases where the agent's interests are shown to be adverse to those of his principal. *Id.* In such cases, it is presumed that such an agent is unlikely to fulfill his fiduciary duty of full disclosure to the principal. *Id.*; Restatement (Second) of Agency § 282(1); *Evanston Bank v. ContiCommodity Services, Inc.*, 623 F. Supp. 1014, 1036 (N.D. Ill. 1985).

Contrary to the defendants' suggestion, even though McLean had become the President of Holdings and Alloyd no longer existed, this court finds that McLean's interests were adverse to those of Holdings. As evidenced by the present case, the inventory shortfall at issue could result in McLean being held liable to Holdings. McLean could therefore have had a personal interest in not telling the other Holding officers about the shortfall. Since McLean's interests were adverse to Holdings, the knowledge he acquired about the shortfall on February 8, 1990 cannot be imputed to Holdings. The statute of limitations period began to run in this case on February 12, 1990, the date when other Holdings officers learned about the discrepancy. Since the plaintiffs filed their complaint on February 11, 1991, one day before the limitations period ran out, the plaintiffs' Section 12(2) claim is not time-barred as the defendants suggest.

The defendants further contend that the plaintiffs' Section 12(2) claim should be dismissed because this provision can only be applied to initial offerings. Although the case law is divided, the trend favors limiting Section

12(2) actions to purchasers in initial offerings. *See, e.g.*, *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682 (3d Cir. 1991); *Pacific Dunlop Holdings, Inc. v. Allen & Company Inc.*, 1991 U.S. Dist. LEXIS 6748 (N.D. Ill. 1991); *Bank of Denver v. Southeastern Capital Group, Inc.*, 763 F. Supp. 1552 (D. Co. 1991); *T. Rowe Price New Horizons Fund, Inc. v. Preletz*, 749 F. Supp. 705 (D. Md. 1990); *Grinsell v. Kidder, Peabody, & Co.*, 744 F. Supp. 931 (N.D. Ca 1990).

This court is persuaded, most notably by the Third Circuit in *Ballay*, that Section 12(2) claims can only arise out of the initial stock offerings. *See* 925 F.2d 682. In a thorough and well-reasoned opinion, the *Ballay* court determined that the language and legislative history of Section 12(2), as well as its relationship to Section 17(a) and 10(b) within the schemes of the 1933 and 1934 Acts, compelled a finding that Section 12(2) only applies to initial offerings and not to after-market trading. *Id.* at 693. The one other court in this district faced with this issue has also agreed with the Third Circuit's analysis. *See Pacific Dunlop Holdings*, 1991 U.S. Dist. LEXIS 6748. Based upon the court's reasoning in *Ballay*, this court therefore concludes that application of Section 12(2) must be restricted to initial distributions.

As the plaintiffs argue, the legislative history of the 1933 Securities Exchange Act suggests that Section 12(2) can be applied to a redistribution of securities if "such redistribution takes on the characteristics of a new offering by reason of the control of the issuer possessed by those responsible for the offering." H.R. No. 85, 73d Cong., 1st Sess. 7 (1933); *Ballay*, 925 F.2d at 690. While the plaintiffs suggest that this language supports their argument that Section 12(2) is applicable, they have provided

this court with no evidence to support their claim that the sale at issue possesses the characteristics of a new offering. At most, the plaintiffs claim that the instant case involved the purchase of stock directly from the controlling shareholders rather than from a stockbroker as was the case in *Ballay*. This claim does not suffice to overcome the court's conclusion that Section 12(2) cannot be applied to this case because other evidence more strongly suggests that the transaction at issue in this case cannot be compared to an initial offering. For example, the parties agree that Alloyd was formed in 1961. *See* Defendants' Statement of Material Facts at ¶ 2. Hence, the transaction at issue in this case occurred approximately 30 years after the initial issuance of Alloyd's stock. *See Bank of Denver*, 763 F. Supp. at 1559. Also, unlike purchasers in most initial offerings, the purchasers in this case had direct access to financial and other company documents, and had the opportunity to inspect the seller's property.

Since the plaintiffs fail to provide this court with adequate evidence showing that the pertinent transaction is not comparable to an initial offering, this court finds that Section 12(2) cannot be applied to the instant case. The court therefore grants defendants' motion to dismiss plaintiffs' Section 12(2) claim.[4] The court also dismisses

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[4] The defendants also contend that the plaintiffs cannot prove the substantive elements of a Section 12(2) claim. There is no need for this court to consider this argument since, upon review of the defendants' arguments, the court finds that these arguments will not affect our decision to grant defendants' motion for summary judgment because the plaintiffs cannot bring a claim under Section 12(2).

plaintiffs' state law breach of contract claim for lack of jurisdiction. Finally, the court denies plaintiffs' motion for summary judgment as moot.

Conclusion

For the reasons stated above, the court grants defendants' motion for summary judgment and denies plaintiffs' motion for summary judgment as moot.

ENTER:

Ann Claire Williams, Judge
United States District Court

Dated: May 29, 1992

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

ALLOYD CO., INC., a Delaware corporation, f/k/a Alloyd Holdings, Inc., and WIND POINT PARTNERS II, L.P., a Delaware limited partnership,	)	Case No. 91 C 889
Plaintiffs,	)	Judge Williams
v.	)	
ARTHUR L. GUSTAFSON, DANIEL R. McLEAN and FRANCIS I. BUTLER,	)	
Defendants.	)	

FIRST AMENDED COMPLAINT

Alloyd Co., Inc. ("New Alloyd") and Wind Point Partners II, L.P. ("Wind Point") (collectively "Plaintiffs"), as their First Amended Complaint against Arthur L. Gustafson ("Gustafson"), Daniel R. McLean ("McLean") and Francis I. Butler ("Butler") (collectively "Defendants"), state as follows:

NATURE OF THE CASE

1. This is an action for rescission, or in the alternative for money damages, arising from the sale of a business by Defendants. In negotiating the sale, Defendants represented and warranted that the financial statements provided to the purchaser, Alloyd Holdings, Inc. ("Holdings"), fairly presented the financial condition and results

of operations of the business. In fact, the financial statements materially overstated earnings and did not fairly represent the financial condition or results of operations of the business. As a result, Holdings substantially overpaid for the business. Defendants violated Section 12(2) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. § 77l(2). Defendants also breached the terms of the Stock Purchase Agreement ("Purchase Agreement") entered into by Holdings and Defendants, because Defendants have refused to indemnify New Alloyd for the losses sustained as a result of their breaches of the representations and warranties.

JURISDICTION AND VENUE

2. This Court has subject matter jurisdiction over this action under 28 U.S.C. § 1331, Section 22(a) of the Securities Act, 15 U.S.C. § 77v(a), and pursuant to principles of supplemental jurisdiction, 28 U.S.C. § 1367(a).

3. Venue is proper in this district pursuant to Section 22(a) of the Securities Act, 15 U.S.C. § 77v(a), and under 28 U.S.C. § 1391(b). All Defendants live and transact business in this district, the offer and sale took place in this district, a substantial amount of New Alloyd's property is situated in this district, and a substantial part of the events or omissions giving rise to the claim occurred here.

4. In connection with the acts and conduct complained of herein, Defendants, directly and indirectly, used means and instrumentalities of interstate commerce, including interstate telephone facilities, the United States

Federal Reserve wire transfer facilities, and the United States mails.

5. New Alloyd is incorporated in the State of Delaware and has its principal place of business at 1401 Pleasant Street, DeKalb, Illinois. New Alloyd manufactures clear plastic blister packaging, heat seal equipment, and tooling for a variety of nonfood consumer product manufacturers in the United States and Canada. New Alloyd was formed as the result of the merger of Old Alloyd into Holdings.

6. Wind Point is a limited partnership organized under the laws of Delaware with its principal place of business at 1525 Howe Street, Racine, Wisconsin.

7. Gustafson resides at 40W011 Burlington Road, St. Charles, Illinois. He was the former President of the business that was sold, Alloyd Co., Inc. ("Old Alloyd"), an Illinois corporation. Gustafson owned approximately 85% of Old Alloyd's stock.

8. McLean resides at 311 Thornbrook, DeKalb, Illinois. He was the former Executive Vice-President of Old Alloyd and owned approximately 10% of its stock.

9. Butler resides at 259 Arlington, Elmhurst, Illinois. He was the former Vice-President of Old Alloyd and owned approximately 5% of its stock.

WIND POINT'S PURCHASE OF OLD ALLOYD

Negotiations

10. On or about August 1989, Wind Point entered into discussions with Defendants concerning the sale of

Old Alloyd. Defendants owned all of the issued and outstanding capital stock of Old Alloyd.

11. On or about October 17, 1989, Defendants signed a binding Letter Agreement ("Letter Agreement") with Wind Point in which Defendants agreed to sell, and Wind Point agreed to purchase, substantially all of the issued and outstanding capital stock of Old Alloyd. Under the terms of the Letter Agreement, the consideration was to consist of, among other things, cash, promissory notes and Wind Point's assumption and repayment of Old Alloyd's debt. Beginning on or about October 18, 1989, Defendants and Wind Point began negotiating the terms of the definitive Purchase Agreement. On or about November 14, 1989, Defendants and Wind Point executed an Amendment to the Letter Agreement.

12. On or about November 17, 1989, to facilitate the acquisition of Old Alloyd, Wind Point created Holdings, a Delaware corporation formed for the purpose of acquiring Old Alloyd.

13. Between November 14, 1989 and December 20, 1989, Defendants and their representatives negotiated with representatives of Wind Point regarding the terms and conditions of the Purchase Agreement, including the representations and warranties concerning Old Alloyd's financial statements. During this same time period, Defendants and Holdings discussed the financial performance of Old Alloyd and historical year-end adjustments to Old Alloyd's inventory figures. At these meetings, McLean represented that negative year-end adjustments to inventory historically had been about $200,000 or less.

14. On or about December 20, 1989, Defendants and Holdings executed the Purchase Agreement. A copy of the Purchase Agreement, not including the Schedules and Exhibits, is attached as Exhibit A.

15. The "Closing Date" was December 22, 1989. Defendants and Holdings executed all necessary documents on the Closing Date. Also on the Closing Date, the cash component of the purchase price paid for the stock and related non-compete agreements was wire transferred to a variety of sources, including the Defendants, Old Alloyd's lenders, Defendants' lenders and the escrow agent. Immediately following consummation of the transaction, Old Alloyd was merged into Holdings. Holdings subsequently changed its name to Alloyd Co., Inc. ("New Alloyd").

Holdings's Valuation of Old Alloyd

16. During negotiations between Defendants and Holdings, Defendants provided Holdings with historical financial data on Old Alloyd. Specifically, Defendants furnished Holdings with consolidated audited balance sheets, income statements, and audited consolidated statements of and sources and applications of funds, for the years 1984 through 1987. Defendants also furnished Holdings with Old Alloyd's 1988 balance sheet and income statement (including a consolidated budget for the fiscal year beginning January 1, 1989). Finally, Defendants furnished Old Alloyd's consolidated unaudited balance sheet and related statements of income for the ten months ended October 31, 1989 (the "Unaudited 1989 Financial Statement").

17. Holdings evaluated all of Old Alloyd's historical financial data. Based on its review of the data, Holdings priced Old Alloyd at a multiple of approximately 7.5 times projected "EBIT" for the year ended December 31, 1989. "EBIT," as used by Holdings and Old Alloyd, meant earnings before income taxes, interest, acquisition related expenses and excess officers' compensation.

18. Based on the Unaudited 1989 Financial Statement, projected 1989 EBIT was $4,881,000. The total consideration Holdings agreed to pay for the stock of Old Alloyd and related non-compete agreements was approximately $37.0 million.

Representations and Warranties

19. Defendants knew that the consideration Holdings was willing to pay for Old Alloyd was based explicitly and directly on projected 1989 EBIT and on the related growth trend of EBIT for the previous five years. Consequently, as an inducement for Holdings to enter into the Purchase Agreement, Defendants jointly and severally provided Holdings with representations and warranties concerning the financial condition and results of operations of Old Alloyd.

20. Among the representations and warranties in the Purchase Agreement were the following.

(a) *Financial Statements*. Defendants represented that the financial statements provided to Holdings, including, among other things, the Unaudited 1989 Financial Statement, "present fairly on a consolidated basis the Company's

financial condition and related results of operations as of the times and for the periods referred to therein." Defendants also represented that the "Company's books of account and financial records fairly reflect the Company's income, expenses and liabilities." (Purchase Agreement Section 4D.)

(b) *No Material Adverse Changes*. Defendants represented that between the date of the Unaudited 1989 Financial Statement and the date of the Purchase Agreement, there were no material adverse changes in or material adverse events "affecting the business, financial condition, operating results, assets, operations or business prospects" of Old Alloyd. (Purchase Agreement Section 4I.)

(c) *Disclosure*. Defendants represented that there were no untrue statements of material fact or material omissions in the Purchase Agreement or any of the attached Schedules or exhibits, nor had Defendants failed to disclose to Holdings any material facts which would adversely affect Old Alloyd's "business, financial condition, operating results, assets, operations or business prospects." (Purchase Agreement Section 4Z.)

(d) *Closing Date*. Defendants represented that all of the representations and warranties in the Purchase Agreement and other documents delivered to Holdings were true and correct on December 20, 1989 and would be true and correct as of the Closing Date. (Purchase Agreement Section 4AA.)

21. On the Closing Date, Defendants delivered a certificate to Holdings reaffirming that the representations and warranties in the Purchase Agreement were true as of the Closing Date.

Plaintiffs Discover Old Alloyd Was Overvalued

22. New Alloyd retained KPMG Peat Marwick ("Peat Marwick") to perform an audit of Old Alloyd for the fiscal year ended December 31, 1989. Immediately after December 31, 1989, Peat Marwick began performing an audit of Old Alloyd for the fiscal 1989 year.

23. On or about February 12, 1990, New Alloyd received Peat Marwick's initial investigative findings, and information from McLean, relating to Old Alloyd's inventory figures. In reviewing the inventory information provided by Peat Marwick and McLean, New Alloyd learned that it was possible the Cost of Goods Sold figures set forth in the Unaudited 1989 Financial Statement were materially in error. Prior to receiving the information on February 12, 1990, Plaintiffs did not know, and could not by the exercise of reasonable diligence have known, that the Unaudited 1989 Financial Statement was materially in error.

24. On or about March 23, 1990, Plaintiffs received the preliminary results of Peat Marwick's audit. In reviewing those results, New Alloyd learned that the inventory figures on the Unaudited 1989 Financial Statement and the figure purportedly representing Old Alloyd's income from operations were so materially in error when the Purchase Agreement was signed (December 20, 1989) and on the Closing Date (December 22, 1989)

that the Unaudited 1989 Financial Statement did not present fairly Old Alloyd's financial condition and related results of operations.

25. Because projected 1989 EBIT was directly based on the income figures in the Unaudited 1989 Financial Statement, New Alloyd came to believe it had overpaid Defendants. The preliminary results of the audit indicated that actual fiscal 1989 EBIT was substantially less than the projection based on the Unaudited 1989 Financial Statement.

26. On or about March 23, 1990, New Alloyd made a written claim for indemnification, pursuant to the Purchase Agreement, against Defendants. That letter claimed that the Defendants had breached the representations and warranties referred to in Paragraph 20 above, which appear in the Purchase Agreement as Sections 4D, 4I, 4Z and 4AA.

27. On or about April 3, 1990 New Alloyd received Peat Marwick's final audited financial statements for Old Alloyd for the 1989 fiscal year. The final audited financial statements revealed that income from operations for 1989 was only \$2,915,000, or \$1,460,676 less than the annualized income from operations based on the ten-month figure stated in the Unaudited 1989 Financial Statement.

28. Based on the final audited statements, Plaintiffs determined that actual 1989 EBIT was \$3,387,000, or \$1,494,000 less than the projection based on the Unaudited 1989 Financial Statement.

29. On or about May 3, 1990, New Alloyd notified Defendants of the adjustments to the 1989 balance sheets.

New Alloyd forwarded a copy of Peat Marwick's final audited 1989 Balance Sheet to Defendants on or about May 9, 1990.

30. Had the true information on EBIT been known at the time of the transaction, Holdings would not have pursued the purchase of Old Alloyd because the acquisition would not have satisfied its customary investment criteria. Even assuming Holdings had chosen to ignore its investment criteria and pursue the acquisition, it would have applied a valuation multiple significantly lower than 7.5 times EBIT to the actual lower EBIT figure.

COUNT I

VIOLATION OF SECTION 12(2) OF THE SECURITIES ACT, 15 U.S.C. § 771(2)

31. Plaintiffs reallege and incorporate Paragraphs 1-30 as Paragraph 31 herein.

32. Defendants offered and sold to Holdings all the issued and outstanding capital stock of Old Alloyd. The capital stock of Old Alloyd constitutes a security as defined in the Securities Act.

33. In making their offer and sale of securities, Defendants used a means of communication in interstate commerce. Specifically, Defendants used the telephone wires, the United States Federal Reserve wire transfer facilities and United States mails.

34. The Purchase Agreement offered and confirmed the sale of Old Alloyd's capital stock to Holdings. Accordingly, the Purchase Agreement is a prospectus, as that term is defined in the Securities Act. Defendants also

orally made representations to Plaintiffs on numerous occasions to induce them to purchase the stock of Old Alloyd.

35. In both the Purchase Agreement and their oral communications, Defendants represented and warranted that, among other things, the Unaudited 1989 Financial Statement fairly and accurately presented the financial condition and results of operations of Old Alloyd. In fact, the Unaudited 1989 Financial Statement was materially misleading because actual 1989 EBIT was significantly lower than represented. Thus, Defendants made false and misleading statements of a material fact or omitted to state a material fact necessary to make the statements, in light of the circumstances under which they were made, not misleading.

36. Plaintiffs (and Holdings) did not know that Defendants' representations and warranties were untrue.

37. Defendants knew, or in the exercise of reasonable care could have known, that their representations and warranties were untrue.

38. Plaintiffs have been damaged by Defendants' misleading statements because New Alloyd substantially overpaid for Old Alloyd. New Alloyd stands ready to tender the shares at any time.

WHEREFORE, Plaintiffs pray that: (1) this Court enter judgment in their favor and against Defendants; (2) order that Plaintiffs' purchase of Old Alloyd be rescinded and that, upon tender of the shares, Defendants return to Plaintiffs the consideration paid, less any income

received; (3) award Plaintiffs their costs, including attorneys' fees; and (4) award Plaintiffs any other relief deemed just and equitable.

COUNT II
BREACH OF CONTRACT

39. New Alloyd realleges and incorporates Paragraphs 1-38 as Paragraph 39 herein.

40. The Purchase Agreement is a contract between New Alloyd (f/k/a Holdings) and Defendants covering the purchase and sale of Old Alloyd.

41. New Alloyd has performed all the obligations required of it by the Purchase Agreement.

42. Under Purchase Agreement Section 7B(a)(i), Defendants agreed to jointly and severally indemnify Holdings and hold it harmless against "any loss, liability, penalty, deficiency, damage, or expense (including reasonable legal expenses and costs)" arising from a breach by Defendants of their representations and warranties.

43. Holdings's right to indemnification under the Purchase Agreement is in addition to any other remedies Holdings may have against the Defendants at law or in equity for breach of the representations and warranties.

44. To facilitate indemnification under the Purchase Agreement, Holdings deposited $4,000,000 of the cash portion of the purchase price into an Escrow Fund. Under Purchase Agreement Section 7B(c)(ii), if the Escrow Fund was sufficient to satisfy a claim, Holdings was required, prior to exercising its other remedies, to make a claim against the Escrow Fund in accordance with the terms of

the Escrow Agreement. The Escrow Agreement provides for arbitration of any disputed claims to the Escrow Fund.

45. Purchase Agreement Section 7B(c)(ii) also provides that, to the extent the Escrow Fund is insufficient to satisfy any loss, Holdings may simultaneously exercise its other remedies against Defendants.

46. On or about March 23, 1990, new Alloyd made a claim against the $4,000,000 Escrow Fund. On or about April 11, 1990, Defendants objected to payment of New Alloyd's claim from the Escrow Fund. Accordingly, New Alloyd has demanded arbitration of its claim to the Escrow Fund.

47. However, because New Alloyd's losses far exceed the $4,000,000 in the Escrow Fund, New Alloyd has demanded that Defendants indemnify them for any loss in excess of $4,000,000, pursuant to the terms of the Purchase Agreement.

48. Defendants have refused to honor their obligation in Purchase Agreement Section 7B(a) to indemnify New Alloyd for "any loss, liability, penalty, deficiency, damage or expense (including reasonable legal expenses and costs)" which New Alloyd sustained as a result of Defendants' breach of their representations and warranties. Accordingly, Defendants have breached the contract.

49. New Alloyd has been damaged by Defendants' breach.

WHEREFORE, New Alloyd prays that this Court: (1) enter judgment in its favor and against Defendants; (2) award it damages for Defendants' breach of contract, in

an amount to be proven at trial, plus legal expenses and costs; and (3) award it any other relief deemed just and equitable.

DATED: March 20, 1991 Respectfully submitted,

/s/ Brian D. Sieve
One of the Attorneys for
Plaintiffs Alloyd Co., Inc.
and Wind Point Partners
II, L.P.

Robert J. Kopecky, Esq.
Brian D. Sieve, Esq.
KIRKLAND & ELLIS
200 East Randolph Drive
Chicago, Illinois 60601
(312) 861-2000

PACIFIC DUNLOP HOLDINGS INCORPORATED, a Delaware Corporation, Plaintiff-Appellant,

v.

ALLEN & COMPANY INCORPORATED, a New York Corporation, Defendant-Appellee.

No. 91-2346.

United States Court of Appeals,
Seventh Circuit.

Argued Sept. 11, 1992.
Decided May 7, 1993.

Buyer of stock brought suit against seller alleging fraud in private stock purchase agreement. The United States District Court for the Northern District of Illinois, James B. Zagel, J., summarily dismissed complaint, and buyer appealed. The Court of Appeals, Manion, Circuit Judge, held that: (1) section of Securities Act prohibiting fraud in a prospectus applies to secondary market transactions, and (2) private stock purchase agreement was a "prospectus," within meaning of section of Securities Act prohibiting fraud in a prospectus.

Reversed and remanded.

Peter J. Meyer, Michael J. Koenigsknecht (argued), Andrew C. Spiropoulos, John W. Raihala, Gardner, Carton & Douglas, Chicago, IL, for plaintiff-appellant.

Derke J. Price, Nick J. DiGiovanni, Lord, Bissell & Brook, Chicago, IL, James C. McMillin (argued), Kevin J. Toner, Werbel, McMillin & Carnelutti, New York City, for defendant-appellee.

Before BAUER, Chief Judge, MANION, Circuit Judge, and MOODY, District Judge.*, **

MANION, Circuit Judge.

This case presents a single issue of law: the scope of section 12(2) of the Securities Act of 1933 (1933 Act), 48 Stat. 74, as amended, 15 U.S.C. § 771, as it involves civil fraud in a security transaction.[1] On October 1, 1987 Pacific Dunlop Holdings Inc. ("Pacific") entered into a stock purchase agreement with GNB Holdings Inc. ("GNB") and its other shareholders, Allen & Company Incorporated ("Allen"), Daniel E. Heffernan and thirteen other individuals. The defendants in this case, Allen, an investment banking firm, owned approximately 20 percent of the stock, and Heffernan owned 6.7 percent.[2]

* Honorable James T. Moody, District Judge for the Northern District of Indiana, is sitting by designation.

** This opinion has been circulated pursuant to Circuit Rule 40(f) among the judges of this court in regular active service. A majority did not favor a rehearing en banc (Circuit Judge Kenneth F. Ripple voted to rehear en banc) on the question of a conflict with Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d 682 (3d Cir.), cert. denied, ___ U.S. ___, 112 S.Ct. 79, 116 L.Ed.2d 52 (1991).

[1] The 1933 Act is codified in 15 U.S.C. §§ 77a et seq. The citations in the opinion will refer to the more familiar sections of the 1933 Act, rather than to the particular sections of the United States Code.

[2] Pacific Dunlop originally brought this appeal against Allen and Heffernan. During the pendency of the appeal Pacific and Heffernan agreed to settle their dispute. On February 18, 1993 we granted Pacific's motion to dismiss Heffernan pursuant to Fed.R.App.P. 42(b). Allen remains as defendant-appellee.

Neither defendant is considered a management shareholder. A few months earlier GNB filed a registration statement with the Securities Exchange Commission in order to make an initial public offering of 5,800,000 shares of common stock, including some stock owned by Heffernan. No securities were ever sold pursuant to the registration statement. GNB abandoned the public offering once it entered into the private stock purchase agreement with Pacific, although the agreement did warrant and represent the truthfulness of the information in the registration statement.

Pacific's purchase of GNB brought its ownership to approximately 92 percent of the outstanding common stock for a total cost of $670 million.[3] GNB is a holding company whose subsidiaries engage in the manufacture and sale of industrial and lead acid batteries and the recovery, smelting and sale of lead. In pertinent part the stock purchase agreement represented that GNB and its subsidiaries were in compliance with environmental laws and regulations, were not subject to any pending or threatened governmental investigation and had disclosed all liabilities or obligations. But in reality, GNB was exposed to and now faces extensive environmental claims, liabilities regarding a government services contract, and occupational disease claims. In part to avoid the liabilities and to expunge itself from the plethora of problems GNB faces, Pacific seeks to rescind the deal.

[3] After the purchase GNB's name was changed to Pacific Dunlop GNB Corporation, the sole common shareholder of GNB Incorporated, which in turn maintains a wholly-owned subsidiary, GNB Industrial Battery Company.

Allen is not interested; it prefers to keep the money rather than regain the stock.

Pacific's complaint asserts that Allen omitted material facts that rendered its representations in the stock purchase agreement false and misleading, constituting fraud in violation of the Securities Act, section 12(2), and the Illinois Securities laws.[4] Allen moved to dismiss the complaint for failing to state a claim upon which relief could be granted. The district court summarily dismissed the complaint, relying upon the Third Circuit opinion in Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d 682 (3d Cir.), cert. denied, ___ U.S. ___, 112 S.Ct. 79, 116 L.Ed.2d 52 (1991).

Section 12(2) prohibits fraud in a prospectus. However, there are many possible interpretations of "prospectus." Section 2(10) contains an explicit definition of prospectus; however, this definition may not control if the context of the securities laws and their legislative history require otherwise. Pacific wants the section 2(10) definition to apply in this case. Because of its broad wording, the definition of prospectus would include the

[4] This case is among several involving these transactions. Heffernan, as a former director of GNB, has sued Pacific for indemnification. See Heffernan v. Pacific Dunlop GNB Corp., 965 F.2d 369 (7th Cir.1992). Pacific separately sued the management shareholders pursuant to section 10(b) of the 1934 Act. See Pacific Dunlop Holdings Inc. v. Robert F. Barosh, No. 91-C-0002, 1991 WL 348494 (N.D.Ill.1991). Two of the management shareholders, in turn, have sued Pacific for breach of contract because Pacific has not paid the final balance due of nearly $23 million. See Stanley N. Gaines v. Pacific Dunlop Holdings Inc., No. 91-C-0025 (N.D.Ill.1991).

stock purchase agreement and provide Pacific relief. Allen, however, wants a more narrow definition, arguing section 12(2) does not apply to secondary market transactions. Case law provides authority on each side of the dispute. Ultimately, we conclude that Pacific has a cause of action, based on the text of the 1933 Act, its legislative history, and the impact of section 12(2) on similar fraud provisions in the security laws.

I. Conflict of Authority

The 1933 Act was passed by Congress during an era in our country's history marked by grave concern over the securities market. Since that time numerous district courts have applied section 12(2) of the 1933 Act to similar facts yielding different results. E.g., Bank of Denver v. Southeastern Capital Group, Inc., 763 F.Supp. 1552, 1558-59 (D.Colo.1991) (and cases cited therein); see 17A J. William Hicks, Civil Liabilities: Enforcement and Litigation Under the 1933 Act, § 6.01, pp. 12-34 (1992). In Ballay, which the district court relied on in this case, investors had purchased outstanding securities of Wickes Corporation from stockbrokers employed by Legg Mason. 925 F.2d at 684. A jury found for the investors and against the brokerage firm for oral misrepresentations concerning the actual value of the stock. Id. at 686. The Third Circuit reversed, holding that section 12(2) applies only to initial distributions, not to after-market trading, based on "the language and legislative history of section 12(2), as well as its relationships to sections 17(a) and 10(b) within the scheme of the 1933 and 1934 Acts." Id. at

693,[5] Cf., Louis Loss, Commentary, The Assault on Securities Act Section 12(2), 105 Harv.L.Rev., 908 (1992).

Although the Supreme Court has not specifically addressed whether section 12(2) applies solely to initial offerings, the Supreme Court assumed to the contrary in Wilko v. Swan, 346 U.S. 427, 74 S.Ct. 182, 98 L.Ed. 168 (1953). In Wilko, investors sued their brokerage firm, Hayden, Stone & Co., pursuant to section 12(2) for misrepresentations concerning the value of the common stock of Air Associates, Incorporated (based on a merger contract with Borg Warner Corporation), and for omitting to state that an Air Associates director was also selling his stock. Id. at 429, 74 S.Ct. at 183-84. The brokerage firm moved to stay the district court proceedings pending arbitration in accordance with their margin agreements with the investors. The district court denied the motion, concluding that arbitration was contrary to the remedies afforded by the 1933 Act. Wilko v. Swan, 107 F.Supp. 75, 79 (1952). The Second Circuit reversed, holding that the congressional policies under the United States Arbitration Act permitted arbitration of the dispute, overriding the 1933 Act. Wilko v. Swan, 201 F.2d 439, 445 (1953). The

[5] A primary distribution is a public offering made on behalf of the issuer. The proceeds realized from the offering will . . . be available to the issuer to be used for corporate purposes. A secondary distribution broadly defined is one made on behalf of some person or persons other than the issuer. 3A Harold S. Bloomenthal, Securities and Federal Corporate Law, § 6.03, p. 4 (1988). "Trading in securities involves transactions by someone other than an issuer; it assumes that the securities are presently outstanding and are being bought and sold in the organized securities market." Id. at § 6.04, p. 5.

Supreme Court reversed the Second Circuit, holding that an arbitration agreement could not waive the provisions of section 12(2) of the 1933 Act, notwithstanding the Arbitration Act. Wilko v. Swan, 346 U.S. at 438, 74 S.Ct. at 188-89.

Although in Wilko the arbitration provision of the margin agreements between the investors and their brokerage firm was the only issue raised in the motion to dismiss the complaint,[6] the posture of the case included the facts that no registration statement had been filed; and the securities involved common stock on the aftermarket, not an intial offering. On these facts the Supreme Court stated:

> In response to a Presidential message urging that there be added to the ancient rule of caveat emptor the further doctrine of "let the seller also beware," Congress passed the Securities Act of 1933. Designed to protect investors, the Act requires issuers, underwriters, and dealers to make full and fair disclosure of the character of securities sold in interstate and foreign commerce and to prevent fraud in their sale. To effectuate this policy, § 12(2) created a special right to recover for misrepresentation which differs substantially from the common-law action

[6] On remand from the Supreme Court, the jury found the securities were exempted from the registration requirements. Wilko v. Swan, 127 F.Supp. 55, 57 (1955). The district court granted a new trial on the section 12(2) claims and rejected the brokerage firm's argument that the 1933 Act was not intended to apply to transactions on a national securities exchange. Id. Thus, the district court's interpretation of the Supreme Court case in Wilko is consistent with the conclusion we reach today.

> in that the seller is made to assume the burden of proving lack of scienter.

Wilko, 346 U.S. at 430-31, 74 S.Ct. at 184-85 (emphasis added; footnotes omitted). Although dicta, the Supreme Court's recognition that section 12(2) applies to dealers[7] stands in opposition to the Third Circuit's holding in Ballay, 925 F.2d 682. This reasoning survived Rodriguez De Quijas v. Shearson/American Express, Inc., 490 U.S. 477, 109 S.Ct. 1917, 104 L.Ed.2d 526 (1989).[8]

Also contrary to the Third Circuit's holding in Ballay stands the Tenth Circuit's opinion in Woodward v. Wright, 266 F.2d 108 (1959). Wright had assigned the majority of his interest in an oil and gas lease to Forrest and Hanna, who decided to sell the lease to Woodward and some fellow businessmen. The district court found that the sellers had mailed a prospectus to the purchasers that contained material false statements, but that the transaction did not violate sections 12(1)-(2). Id. at 112. The Tenth Circuit first ruled that the oil and gas lease involved a security sale within the meaning of the 1933

[7] The 1933 Act defines a "dealer" to include a broker. Section 2(12). Contrary to the Wilko and Ballay decisions which involved brokers, the present case involves a direct sale between the stock owners and purchasers pursuant to a stock purchase agreement. We do not need to address any question under section 12(2) as to who may be liable; rather, we need only address whether the scope of section 12(2) liability includes the type of securities sold in this case.

[8] The Supreme Court in Rodriguez De Quijas overruled Wilko; parties may now agree to arbitrate claims under the Securities Act, notwithstanding the waiver provision of section 14. Rodriguez De Quijas, however, did not comment on section 12(2).

Act. Id. at 114. Second, "[t]he whole transaction was a closely knit arrangement among friends and acquaintances, and was conducted on a personal basis. All of the purchasers apparently entered into the transaction with sophisticated discernment." Id. at 115 (emphasis and citation omitted). Thus, the court concluded that the single transaction was not a public offering and did not violate section 12(1)[9] by failing to file a registration statement. Finally, on the question of section 12(2) liability, the Tenth Circuit reversed the district court in favor of the purchasers.

> [T]he [s]ection [12(2)] remedy is applicable to the sale of all securities (with exceptions not here material) whether exempt from the registration requirements or not, or whether the sellers were issuers for the purpose of public offering or not.

Woodward, 266 F.2d at 116. As in the Wilko decision, in Woodward neither the parties nor the court directly addressed whether section 12(2) applied solely to initial offerings. Nevertheless, the Tenth Circuit upheld a section 12(2) claim in a case where no registration statement was required and the sale of the securities involved a secondary market transaction.[10] The Tenth Circuit thus assumes a different application of section 12(2) than that required of the Third Circuit in Ballay.

[9] The court identified sections 12(1-2) as sections 9(1-2), reflecting the numerical change of the 1954 amendments. Woodward, 266 F.2d at 111.

[10] The Tenth Circuit has since followed its Woodward decision, applying the same analysis to similar facts. Gilbert v. Nixon, 429 F.2d 348, 356-59 (1970).

Likewise, the First Circuit has allowed a section 12(2) claim involving a secondary market transaction. In Cady v. Murphy, 113 F.2d 988, 989 (1st Cir.), cert. denied, 311 U.S. 705, 61 S.Ct. 175, 85 L.Ed. 458 (1940), a securities broker had persuaded Murphy to purchase voting trust certificates of South American Utilities Corporation, which were part of a block of shares that had previously been held by E.E. Smith & Company. The court noted indirectly that the sale was not required to be registered, and held that section 12(2) imposed liability "for misrepresentations not only upon principals, but also upon brokers when selling securities owned by other persons." Id., 113 F.2d at 990. As in the Wilko and Woodward decisions, neither the parties nor the court directly addressed whether section 12(2) applied solely to initial offerings. But in Cady the First Circuit did uphold a section 12(2) claim in a case where no registration statement was required and the sale of the securities involved outstanding stock. Thus, the Third Circuit's opinion in Ballay stands in opposition to what the First and Tenth Circuits have already permitted. For the reasons which follow, we depart from the Third Circuit and hold that section 12(2) includes secondary market transactions.

II. The Text of the 1933 Act

"The starting point in every case involving construction of a statute is the language itself." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756, 95 S.Ct. 1917, 1935, 44 L.Ed.2d 539 (1975). Section 12 states that any person who

> (1) offers or sells a security in violation of section 5, or
>
> (2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

The parties admit that their stock purchase agreement is not exempted by the provisions of section 3(a)(2) and that they have availed themselves of means and instruments in interstate commerce and the mails. The parties would leave for trial whether the stock purchase agreement actually contains a misstatement or omission of material fact. For purposes of the motion to dismiss, the parties only dispute whether their stock purchase agreement was "by means of a prospectus or oral communication" and

whether Congress intended that the 1933 Act should apply in the present case.[11]

Specifically, Pacific argues that the stock purchase agreement in this case falls under the definition of a prospectus in section 2(10) of the 1933 Act because the stock purchase agreement was a communication of an offer to sell securities. Allen responds that the agreement does not fit within the definition. It argues that section 2 begins with the phrase "When used in this title, unless the context otherwise requires . . . ," and that the context of section 12(2) requires a different definition than section 2(10). Finally, Allen argues that the legislative history illustrates that Congress intended the civil fraud remedy of section 12(2) to encompass only initial offerings.

A. The section 2(10) definition of prospectus.

Section 2 of the 1933 Act defines certain terms of art ("prospectus", "sale", "offer" and "security") very broadly. A prospectus includes a variety of communications, and specifically exempts others. The prospectus also must involve the offer or sale of a security. We begin with a look at each of these key definitions.

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[11] Allen also moved the district court to dismiss the complaint for failure to plead fraud with particularity, failure to allege Allen itself (rather than the corporation and the management shareholders) made any false representations in the stock purchase agreement and failure to allege the plaintiffs' reasonable efforts in bringing the action within the statute of limitations period. Allen may again raise these arguments before the district court. They were neither briefed nor argued to this court, and we take no position on their merit.

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security,. . . .

* * *

(3) The term "sale" or "sell" shall include every contract of sale or disposition of a security or interest in a security, for value. The term "offer to sell", "offer for sale", or "offer" shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value. . . .

* * *

(10) The term "prospectus" means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security; except that

(a) a communication sent or given after the effective date of the registration statement (other than a prospectus permitted under subsection (b) of section 10) shall not be deemed a prospectus if it is proved that prior to or at the same time with such communication a written prospectus meeting the requirements of subsection (a) of section 10 at the time of such communication was sent or given to the person to whom the communication was made, and

> (b) a notice, circular, advertisement, letter, or communication in respect of a security shall not be deemed to be a prospectus if it states from whom a written prospectus meeting the requirements of section 10 may be obtained, and, in addition, does no more than identify the security, state the price thereof, state by whom orders will be executed, and contain such other information as the Commission, by rules or regulations deemed necessary or appropriate in the public interest and for the protection of investors, and subject to such terms and conditions as may be prescribed therein, may permit.

Without citation, Allen argues that the stock purchase agreement in this case does not fit within the definition of prospectus in section 2(10). In its brief Allen claims that "A privately negotiated contract is simply not a communication, such as those listed in section 2(10), which is designed to entice buyers, . . . [nor does it] 'confirm[ ] the sale of any security.' " From Allen's standpoint, this is an optimistically narrow reading. Pacific properly cites Byrnes v. Faulkner, Dawkins & Sullivan, the breadth of which underscores the section 2(10) definition:

> In 1941, . . . the SEC's general counsel issued an opinion to the effect that the term "prospectus" included "within its meaning an ordinary confirmation," as well as "every kind of written communication . . . which constitutes a contract of sale or disposition of a security for value." Securities Act Release No. 2623 (1941), reprinted in 11 Fed.Reg. 10964 (1946). A 1954 statutory amendment incorporated this opinion in substance into the language of Section 2(10) of the 1933 Act as quoted above; the congressional reports explicitly referred to the 1941 opinion

> and stated that the amendment was adopted in order to avoid any implied repeal of "settled interpretations" of the original text of Section 2(10). S.Rep. No. 1036 at 12, H.R.Rep. No. 1542 at 21, 83d Cong., 2d Sess. (1954), U.S.C.C.A.N. 1954, p. 2973.

550 F.2d 1303, 1309 (2d Cir.1977). A prospectus thus includes a contract of sale or any other kind of written communication that disposes of a security. The stock purchase agreement in this case evidences that Allen would sell and that Pacific would purchase over six million shares of stock. And the agreement represents information given and received by all parties which led to this present dispute. Thus, Allen cannot seriously deny that the stock purchase agreement was a written communication involving the sale of securities. See Sanders v. John Nuveen & Co., 619 F.2d 1222, 1225 (7th Cir.1980) (finding commercial paper reports constituted a prospectus), cert. den. sub nom., 450 U.S. 1005, 101 S.Ct. 1719, 68 L.Ed.2d 210 (1981); accord Short v. Belleville Shoe Mfg. Co., 908 F.2d 1385, 1390 (7th Cir.1990) (a prospectus includes "materially incorrect or misleading selling literature."), cert. denied, ___ U.S. ___, 111 S.Ct. 2887, 115 L.Ed.2d 1052 (1991).

Because the 1933 Act contains only one explicit definition of prospectus, one conclusion would be that the term prospectus means the same throughout the 1933 Act. This would boost Pacific's argument that section 12(2) incorporates the section 2(10) definition. However, if the 1933 Act contemplates more than one definition of prospectus, Pacific's argument of whether a certain definition applies is weakened by asking which definition

applies. See Balley, 925 F.2d at 688-89. A comparison with the definition of "registration statement" helps to provide guidance. The 1933 Act primarily deals with three areas: the registration statement, the prospectus, and fraud. The section defining registration statement (Section 2(8)) incorporates section 6 as follows:

> The term "registration statement" means the statement provided for in section 6, and includes any amendment thereto and any report, document, or memorandum filed as part of such statement or incorporated therein by reference.

But section 2(10), which defines "prospectus," does not confine itself to "the statement provided for in section 10," or other such language. This permits the inference that section 10 involves only one type of prospectus. The inference finds support in the definitional section of prospectus, because certain communications are exempted from the term "prospectus" where the communication includes the delivery of a section 10 prospectus or states from whom such a document may be obtained. Section 2(10)(a-b). Thus, certain communications could be classified as prospectuses under section 2(10) without complying with section 10.

Section 10(d) provides the best indication that no single definition similarly applies throughout the 1933 Act. In this section the Commission is given the

> authority to classify prospectuses [under section 10] according to the nature and circumstances of their use or the nature of the security, issue, issuer, or otherwise, and, by rules and regulations and subject to such terms and conditions as it shall specify therein, to prescribe as to each class the form and contents which it may find appropriate and consistent with the public interest and the protection of investors.

Thus, the 1933 Act contemplates many definitions of a prospectus. Section 2(10) gives a single, broad definition; section 10(a) involves an isolated, distinct document – a prospectus within a prospectus; section 10(d) gives the Commission authority to classify many. See 17 C.F.R. §§ 230.134, 230.153, 230.420-230.432. Which definition did Congress contemplate in section 12(2)? The definitional section 2 begins with the phrase "When used in this title, unless the context otherwise requires. . . . " (Emphasis added.) This leads to an analysis of the context of a prospectus and whether section 12(2) requires a definition of prospectus contrary to the broad definition of section 2(10).

B. The context of prospectus.

In Rowland v. California Men's Colony, ___ U.S. ___, 113 S.Ct. 716, 121 L.Ed.2d 656 (1993), an inmate association sued various prison officials under 42 U.S.C. § 1983. The issue was whether an association fell under the definition of person in 28 U.S.C. § 1915(a), in order to proceed in forma pauperis. The Court focused on the definition of "person" in the Dictionary Act, 1 U.S.C. § 1. That section began with the phrase: "[i]n determining the meaning of any Act of Congress, unless the context indicates otherwise." Rowland, ___ U.S. at ___, 113 S.Ct. at 720 (emphasis added). Although the present case involves the work "requires" rather than "indicates," the Court's discussion of the work "context" is particularly instructive.

> "Context" here means the text of the Act of Congress surrounding the word at issue, or the texts of other related congressional Acts, and this is simply an instance of the word's ordinary meaning: "[t]he part or parts of a discourse preceding or following a 'test' or passage or a word, or so intimately associated with it as to throw light upon its meaning." Webster's New International Dictionary 576 (2d ed. 1942). While "context" can carry a secondary meaning of "[a]ssociated surroundings, whether material or mental," ibid., we doubt that the broader sense applies here. The Dictionary Act uses "context" to give an instruction about how to "determin[e] the meaning of a[n] Act of Congress," a purpose suggesting the primary sense. If Congress had meant to point further afield, as to legislative history, for example, it would have been natural to use a more spacious phrase, like "evidence of congressional intent," in place of "context."

Id., ___ U.S. at ___, 113 S.Ct. at 720. The 1933 Act does not define "context." Pacific argues that the context of prospectus when used in section 12(2) concerns only the language in that particular section. See American Bankers Ass'n v. S.E.C., 804 F.2d 739, 753-55 (D.C.Cir.1986). As a general rule, "[t]he context of a particular sentence or clause in a statute . . . comprises those parts of the text which immediately precede and follow it." Black's Law Dictionary 320 (6th ed. 1990). Allen, on the other hand, argues that the context of prospectus concerns the scope of the entire 1933 Act, including its legislative history. If prospectus is defined in such a broad context, Allen asserts that the totality of the 1933 Act and its legislative history would demonstrate that section 12(2) was not

intended to include secondary market transactions. An overview of the 1933 Act will help provide guidance.

The 1933 Act consists of twenty-six sections and two schedules. Section 2 merely defines the majority of important terms. Section 3 lists specific exemptions to which the Act will generally not apply, including securities classified as reserved, and securities issued by the federal or state governments, banks, savings and loan associations, non-profit organizations, certain railroad trusts, bankruptcy certificates and insurance policies. Section 4 exempts certain transactions from the requirement that a registration statement be effective before selling the securities. Section 5 details the prohibitions where a registration statement has not become effective. Section 7 states the information required in the registration statement and accompanying schedules. Section 10 details the information required in a prospectus. Section 11 provides for civil liabilities for false information in any part of the registration statement, describing who may be sued, the shifting burdens of proof, the standard of negligence and the calculation of damages. The section we are most concerned with here, section 12, quoted supra, provides for civil liability for selling a security without an effective registration statement or for false information in a "prospectus or oral communication." Section 13 provides specific statute of limitations periods for the civil liability provisions of sections 11 and 12. Section 17 is a catch-all provision that makes fraudulent interstate security transactions unlawful. Section 24 makes a willful violation of any of the foregoing sections a criminal matter, involving a fine of not more than $10,000 or imprisonment of not more than five years or both.

The Third Circuit found the structure of the 1933 Act particularly instructive:

> Section 12(2) follows section 11 and section 12(1), which govern the registration of securities and create civil liability for sales of unregistered securities, respectively, and appears before section 13, which provides the statute of limitation for both sections 11 and 12. All of these sections deal with initial distributions. 15 U.S.C. §§ 77k, 771(1). Congress' placement of section 12(2) squarely among the 1933 Act provisions concerned solely with initial distributions of securities indicates that it designed section 12(2) to protect buyers of initial offers against fraud and misrepresentation.[12]

[12] The Third Circuit states that sections 11, 12(1) and 13 are "concerned solely with initial distributions of securities." Ballay, 925 F.2d at 691. This is not "solely" the case. See, e.g., Byrnes v. Faulkner, Dawkins & Sullivan, 550 F.2d 1303, 1307 (2d Cir.1977) (involving a registered secondary distribution). Sections 11 and 12(1) reference registration statements. They do not even mention language such as "initial" or "secondary". For example, registration statements are required in public offerings; certain private offerings are exempt. Section 4(2). The public/private and initial/secondary are two entirely different questions. As a general rule, a seller that publicly offers stock must register the security, whether the sale involves an initial issue or a secondary market transaction. Likewise, a qualified private security sale would be exempt from sections 5 and 12(1), whether the sale involved an initial issue or a secondary market sale. Telling the practical difference between the two can also prove difficult. Barnes v. Osofsky, 373 F.2d 269, 272-73 (2d Cir.1967). With respect to issuers, underwriters or dealers, all securities must be registered, again notwithstanding whether the sale involves an initial issue or a secondary market transaction. Section 4(1).

Ballay, 925 F.2d at 691. The 1933 Act is primarily concerned with only two documents – registration statements and prospectuses. They are dealt with in that order: Section 2 defines a registration statement (2(8)) and then a prospectus(2(10)). Section 6 details the registration statement and section 10 the prospectus. Section 11 applies to fraud in the registration statement and section 12 applies to fraud in the prospectus. The Third Circuit focused on this structure as the "context [that] otherwise requires" a prospectus to be confined to initial distributions. Section 2. We do not read the word "context" as broadly. Prior to Ballay, neither had the Third Circuit. Ruefenacht v. O'Halloran, 737 F.2d 320, 330-32 (3d Cir.1984), aff'd sub nom. 471 U.S. 701, 105 S.Ct. 2308, 85 L.Ed.2d 708 (1984). See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 200, 96 S.Ct. 1375, 1384, 47 L.Ed.2d 668 (1976).

> The ascertainment of congressional intent with respect to the scope of liability created by a particular section of the Securities Act must rest primarily on the language of that section. The broad remedial goals of the Securities Act are insufficient justification for interpreting a specific provision "more broadly than its language and statutory scheme reasonably permit." We must assume that Congress meant what it said.

Pinter v. Dahl, 486 U.S. 622, 653, 108 S.Ct. 2063, 2081-82, 100 L.Ed.2d 658 (1988) (emphasis added; citations omitted). The structure of the entire 1933 Act cannot qualify as the context in which a prospectus should be defined. Such an approach would result in an entirely new definition in the place of section 2(10). Also, nothing in the structure of the 1933 Act requires a different definition of prospectus in section 12(2) than that contained in section

2(10). Thus, we confine our inquiry of the context of the word "prospectus" to the language of section 12. Rowland, ___ U.S. at ___, 113 S.Ct. at 720.

Section 12(1) of the Act specifically applies to a person who offers or sells a security in violation of section 5. In pertinent part, section 5 states that

> (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly –
>
> (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; . . .
>
> (c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer or to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security. . . .

By combining sections 5 and 12(1), the general rule is that a person may not offer or sell a security by means of "any prospectus or otherwise" without filing a registration statement. See A.C. Frost & Co. v. Coeur D'Alene Mines Corp., 312 U.S. 38, 41-42, 61 S.Ct. 414, 416, 85 L.Ed. 500 (1941). This would imply that a prospectus cannot exist without a registration statement. But this implication is not necessarily true.

The exemptions to section 5 include approximately twelve classes of securities listed in section 3 and the six

classes of transactions listed in section 4. If a security transaction is exempted under sections 3 or 4, a person will not incur section 12(1) liability pursuant to section 5. The question is whether these same exemptions apply to section 12(2).[13] Section 3 begins with the phrase "Except as hereinafter expressly provided." Section 12(2) expressly provides that fraud in a prospectus is actionable, "whether or not exempted by the provisions of section 3," unless the security falls under section 3(a)(2) (dealing only with securities issued by the federal and state governments and banks). Thus, only one of twelve classifications of securities exempted under section 3 is not actionable for a violation under section 12(2). As a result, section 12(2) applies to a much broader range of securities than sections 5 or 12(1). Section 4 begins with the phrase "The provisions of section 5 shall not apply to. . . . " If Congress had wanted the section 4 exemptions to apply to sections 12(1) and 12(2) alike, Congress simply could have begun section 4 by stating "The provisions of sections 5 and 12 shall not apply to. . . . " The courts have consistently held that the section 4 exemptions do not apply to section 12(2). Wright v. National Warranty Co., L.P., 953 F.2d 256, 262 (6th Cir.1992) (the securities were exempt from registration requirements pursuant to section 4(2), yet the case was remanded based on section

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[13] In the context of Regulation D limited offerings, the Commission, in exempting certain transactions from the scope of the registration requirements of section 5, has stated that "Such transactions are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws." 17 C.F.R. § 230.501 et seq. (Preliminary notes). Thus, the Commission interprets section 5 as not limiting section 12(2).

12(2)); Haralson v. E.F. Hutton Group, Inc., 919 F.2d 1014, 1032 (5th Cir.1991); Nor-Tex Agencies, Inc. v. Jones, 482 F.2d 1093, 1099 (5th Cir.1973), cert. denied, 415 U.S. 977, 94 S.Ct. 1563, 39 L.Ed.2d 873 (1974); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 695 (5th Cir.1971); Woodward v. Wright, 266 F.2d 108, 116 (10th Cir.1959); see Landreth Timber Co. v. Landreth, 471 U.S. 681, 694-95 n. 7, 105 S.Ct. 2297, 2307 n. 7, 85 L.Ed.2d 692 (1985). To apply the exemptions of sections 3 and 4 to section 12(2) would also collapse any distinction between sections 3 and 4. In Landreth, the Supreme Court rejected the sale of business doctrine. The petitioner had sought rescission of stock pursuant to section 12(1) of the 1933 Act (for failure to register the securities) and fraud damages pursuant to the 1934 Act. Id., 471 U.S. at 684, 105 S.Ct. at 2300-01. Although the case did not involve prospectus fraud under section 12(2), the Court stated

> The 1934 Act contains several provisions specifically governing tender offers, disclosure of transactions by corporate officers and principal stockholders, and the recovery of short-swing profits gained by such persons. Eliminating from the definition of "security" instruments involved in transactions where control passed to the purchaser would contravene the purposes of these provisions. Furthermore, although § 4(2) of the 1933 Act exempts transactions not involving any public offering from the Act's registration provisions, there is no comparable exemption from the antifraud provisions.

Id. at 692, 105 S.Ct. at 2305 (emphasis added; citations omitted). Finally, a statute that states when a registration statement is required does not necessarily dictate when a

prospectus materializes.[14] See, e.g., Capri v. Murphy, 856 F.2d 473, 476 (2d Cir.1988).

For example, suppose section 5 stated that unless the state issued a person a firearms license, a person could not carry a handgun; and section 12(2) made it unlawful to kill another person while using a handgun. Certainly a person (whether or not he had a firearms license) would violate section 12(2) by using a handgun to kill another person, even though section 5 contemplates a person using a handgun only after first being issued a firearms license. The analysis does not aid in defining what constitutes a handgun. In the same manner, although section 5 contemplates a registration statement prior to a prospectus, an examination of section 5 does not assist in defining the term prospectus in section 12(2). Therefore, nothing in section 12(1) requires a different definition of prospectus in section 12(2) than that contained in section 2(10).

Section 12(2) forbids fraud "by means of a prospectus or oral communication." Pacific argues that the addition of the words "oral communication" broadens the definition of prospectus, although they clearly are neither arguing that the stock purchase agreement is an oral communication nor that other oral communications are at issue in this case. The 1933 Act does not define "oral communication." We agree with the Third Circuit that the term "oral communication" is restricted to those oral communications relating to a prospectus. Ballay, 925 F.2d

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[14] Note that even where a registration statement is not required, sellers are free to voluntarily register their securities. Section 6 ("Any security may be registered").

at 688, citing Schreiber v. Burlington Northern Inc., 472 U.S. 1, 8, 105 S.Ct. 2458, 2462, 86 L.Ed.2d 1 (1985) ("words grouped in a list should be given related meaning" (citation omitted)).

> This reading comports with the canon of construction noscitur a sociis, which instructs that a provision should not be viewed "in isolation but in the light of the words that accompany it and give [it] meaning." Massachusetts v. Morash, 490 U.S. 107, 115, 109 S.Ct. 1668, 1673, 104 L.Ed.2d 98 (1989). As the Supreme Court noted when construing the meaning of one term in a phrase:
>
> [t]he maxim noscitur a sociis, that a word is known by the company it keeps, while not an inescapable rule, is often wisely applied where a word is capable of many meanings in order to avoid the giving of unintended breadth to the Acts of Congress. Jarecki v. G.D. Searle & Co., 367 U.S. 303, 307, 81 S.Ct. 1579, 1582, 6 L.Ed.2d 859 (1961).

Ballay, 925 F.2d at 688. The words "oral communication" are words of form, not substance; they describe how one communicates a message, not the message content. Whether the term prospectus in section 2(10) is found to include a certain message, certainly Congress intended the same words, though spoken orally, to enjoy exactly the same treatment. A prospectus in section 2(10) includes a "prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television." By adding "or oral communication" in section 12(2), Congress was just adding oral communications to the section 2(10) list. The key to defining prospectus,

however, is not in the listed communication media, but rather in whether the substance of the words used offers to sell or confirm the sale of a security.

In this case the parties dispute the definitional scope of prospectus in section 12(2). Allen argues to confine a prospectus to initial offerings; Pacific wants the broad definition in section 2(10) to apply. Section 2(10) is broad enough to include initial and secondary market transactions. But section 2 begins with the phrase "When used in this title, unless the context otherwise requires. . . ." Although the 1933 Act may contain more than one definition of a prospectus, considering the foregoing analysis, we cannot say that the structure of the 1933 Act, the text of section 12, and in particular the context of the word "prospectus" in section 12(2), require a definition of prospectus contrary to the broad definition of section 2(10). The text of the 1933 Act refutes Allen's contention that section 12(2) applies only to initial offerings. Allen nevertheless argues that the legislative history shows Congress' intention to limit the scope of civil liability under the 1933 Act.[15]

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[15] In the context of an initial offering memorandum, the Supreme Court has held that section 28(a) of the Securities and Exchange Act of 1934 (1934 Act) does not require a rescissionary recovery under section 12(2) of the Securities Act or section 10(b) of the Exchange Act to be offset by any tax benefits received from a tax shelter investment. Randall v. Loftsgaarden, 478 U.S. 647, 667, 106 S.Ct. 3143, 3155, 92 L.Ed.2d 525 (1986). In looking to the rescissionary wording of section 12(2), the Court cited the usual phrase that "the starting point in construing a statute is the statute itself" and concluded that section 12(2) "speaks with the clarity necessary to invoke this 'plain meaning' canon." Id., 478 U.S. at 656, 106 S.Ct. at 3149. However, the

III. The Legislative History of the 1933 Act

In Rowland, the Court indicated that in a statute involving language conditioned upon its "context," legislative history should not affect the decisionmaking. Id., ___ U.S. at ___, 113 S.Ct. at 720. Thus, in the present case we could rest on our analysis up to this point. We will nevertheless address the legislative history, because the district court followed Ballay, which relied extensively on legislative history. While we reject Ballay's legislative history analysis, we also note that Rowland appears to reject any reliance upon legislative history for "context" purposes.

In Ballay the Third Circuit placed emphasis on the legislative history of the 1933 Act to illustrate Congress' intent that section 12(2) "regulate initial offerings." 925 F.2d at 690 (relying on the object and structure of the Act and citations to the House Report, H.R.Rep. No. 85, 73d Cong., 1st Sess. (1933)). We will begin by briefly tracing the pertinent legislative history from the House, then from the Senate and finally Congress's compromise of both versions.[16] The final House version of section 12(2)

Court has confined its interpretation of section 12 rescission to a remedy analysis; in determining "seller" status under section 12(1), the Court has stated "there is no indication that Congress employed the remedy for its delineation of potential defendants." Pinter v. Dahl, 486 U.S. 622, 647-48 n. 23, 108 S.Ct. 2063, 2079 n. 23, 100 L.Ed.2d 658 (1988). Thus, Randall does not confine our analysis to the plain meaning of section 12(2). Rather, the Court has continued to look at the legislative history in securities cases.

[16] [G]eneralized references to the remedial purposes of the securities laws will not justify reading a provision more broadly

proposed by the House Interstate and Foreign Commerce Committee stated that:

> Sec. 12. Any person who – (2) sells a security (whether or not exempted by section 3), by the use of any means of instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of material fact or omits to state a material fact (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such truth or omission, shall be liable to the person purchasing such security from him. . . .

H.R. 5480, 73d Cong., 1st Sess. (1933), as passed by the House on May 5, 1933, 3 Ellenberger & Maher, item 26, at 25. Pursuant to this version, the House Report made the following comments about the Act:

> The character of civil liabilities imposed by this bill are described in detail elsewhere. Their essential characteristic consists of a requirement that all those responsible for statements upon the face of which the public is solicited to invest

than its language and the statutory scheme reasonably permit. Thus, if the language of a provision of the securities laws is sufficiently clear in its context and not at odds with the legislative history, it is unnecessary to examine the additional considerations of policy that may have influenced the lawmakers in their formulation of the statute. Aaron v. SEC, 446 U.S. 680, 695, 100 S.Ct. 1945, 1955, 64 L.Ed.2d 611 (1980) (citations and quotations omitted).

its money shall be held to standards like those imposed by law upon a fiduciary.

* * *

The bill affects only new offerings of securities. . . . It does not affect the ordinary redistribution of securities unless such redistribution takes on the characteristic of a new offering by reason of the control of the issuer possessed by those responsible for the offering.

H.R.Rep. No. 85, 73d Cong., 1st Sess. (1933), to accompany H.R. 5480, May 4, 1933, 2 Ellenberger & Maher, item 18, at 5 (emphasis added).

In view of these [transaction and security] exemptions and the restriction of the bill's application to new offerings, the bill does not affect transactions beyond the need of public protection.

Id. at 7 (emphasis added).

Section 10 of the bill requires that any "prospectus" used in connection with the sale of any securities, if it is more than a mere announcement of the name and price of the issue offered and an offer of full details upon request, must include a substantial portion of the information required in the "registration statement." The Commission is given power to classify prospectuses according to the nature and circumstances of their use and to prescribe the form and contents appropriate to each class. While a leeway is given to the Commission to meet the varying exigencies of business transactions, fundamental safeguards necessary to insure a fair disclosure are to be preserved.

"Prospectus" is defined in section [2(10)] to include "any prospectus, notice, circular, advertisement, letter, or other communication offering any security for sale."

The purpose of these sections is to secure for potential buyers the means of understanding the intricacies of the transaction into which they are invited. The full revelations required in the filed "registration statement" should not be lost in the actual selling process. This requirement will undoubtedly limit the selling arguments hitherto employed. That is its purpose. . . . Any objection that the compulsory incorporation in selling literature and sales argument of substantially all information concerning the issue, will frighten the buyer with the intricacy of the transaction, states one of the best arguments for the provision.

Id. at 8 (emphasis added).

Sections 11 and 12 create and define the civil liabilities imposed by the act and the machinery for their enforcement which renders them practically valuable. Fundamentally, these sections entitle the buyer of securities sold upon a registration statement including an untrue statement or omissions of material fact, to sue for recovery of his purchase price, or for damages not exceeding such price, those who have participated in such distribution either knowing of such untrue statement or omission or having failed to take due care in discovering it. . . .

The committee emphasizes that these [civil] liabilities attach only when there has been an untrue statement of material fact or an omission

> to state a material fact in the registration statement or the prospectus – the basic information by which the public is solicited.

Id. at 9 (emphasis added). This discussion of sections 10-12 and the definition of prospectus show that, in the main, prospectuses arise after registration statements are filed; thus the reason that the prospectus "must include a substantial portion of the information required in the 'registration statement.' " The broad definition of a prospectus in section 2(10) prevented sellers from thwarting the registration statement provisions by artfully drafting subsequent "selling literature." In discussing the exemptions to the requirement of filing a registration statement, the House Report continued:

> The provisions of this section [4] exempt certain transactions from the provisions of section 5, which section requires both the registration of securities as a condition precedent to offering them for sale . . . , and which section also requires that after the effective date of registration prospectuses relating to such securities shall conform to the requirements of the act.
>
> Paragraph (1) broadly draws the line between distribution of securities and trading in securities, indicating that the act is, in the main, concerned with the problem of distribution as distinguished from trading. It, therefore, exempts all transactions except by an issuer, underwriter, or dealer.

Id. at 15. Based on the House Report, the legislative history of the 1933 Act can be read to focus on those offerings requiring a registration statement, or as the Third Circuit interprets, to initial offerings.

The Senate, however, proceeded along a different course. The final Senate version of section 12(2) (contained in section 9 of the Senate's version) proposed by the Senate Banking and Currency Committee, see S. 875, May 8, 1933, 77 Cong.Rec. 2996-3000 (1933), 1 Ellenberger & Maher, item 8, at 2998, stated that:

> [Sec. 12]. Every person acquiring any security by reason of any false or deceptive representation made in the course of or in connection with a sale or offer for sale or distribution of such securities shall have the right to recover any and all damages suffered by reason of such acquisition of such securities from the person or persons signing, issuing, using, or causing, directly or indirectly, such false or deceptive representation, jointly or severally.

H.R. 5480, 73d Cong., 1st Sess. (1933), as passed the Senate with Senate amendments May 10, 1933, 3 Ellenberger & Maher, item 27, at 60 (emphasis added). The Senate's version of the 1933 Act allowed recovery for fraud in the sale of "any security," not just those involved in initial offerings. The Senate rarely mentioned the word "prospectus," and certainly not in the fraud context of section 12(2).[17] And the Senate, as compared with the House, did not draft as detailed a report in support of the bill. Although the Senate did not as extensively explain its version, the differing texts display a distinctive treatment on their face.

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[17] The Supreme Court has noted that the legislative history of section 12(2) is "sparse". Randall, 478 U.S. at 657, 106 S.Ct. at 3149-50.

A conference by the House and Senate resulted in the 1933 Act as now codified in 15 U.S.C. §§ 77a et seq. After the conference by the House and Senate, the managers on the part of the House attached a commentary to the final version, addressing the distinctions and the resolution between the previous versions:

> The Senate amendment imposed liability upon persons making false and deceptive statements in connection with the distribution or sale of a security. The House bill made the liability depend upon the making of untrue statements or omissions to state material facts. This phrase has been clarified in the substitute to make the omission relate to the statements made in order that these statements shall not be misleading, rather than making a mere omission – unless the act expressly requires such a fact to be stated – a ground for liability where no circumstances exist to make the omission itself misleading.
>
> The House bill (sec. 12) imposes civil liability for using the mails or the facilities of interstate commerce to sell securities (including securities exempt, under section 3, from other provisions of the bill) by means of representations which are untrue or misleading by reason of omissions of material facts. The substantially similar provisions of the Senate amendment did not apply to any of the securities exempted under the Senate amendment. The substitute exempts from the operation of this section sales of securities covered by section 3(a)(2), which relates, broadly speaking, to securities issued or guaranteed by the United States or any State, Territory, or the District of Columbia, or by a public instrumentality, or by a Federal Reserve bank or national bank, or by a supervised State bank.

Conference Report submitted in House and agreed to, May 22, 1933, 77 Cong.Rec. 3891-3902 (1933), 1 Ellenberger & Maher, item 13, at 3902 (emphasis added); H.R.Rep. No. 152, 73d Cong., 1st Sess. (1933) (Conference Report) to accompany H.R. 54809, May 20, 1933, 2 Ellenberger & Maher, item 19, at 26 (emphasis added).[18] Allen in this case points to section 12(c) of the Senate's final version (not included in the final 1933 Act) to show that the Senate intended the civil fraud provisions to apply only to initial offerings.

> Section 12. Except as hereinafter otherwise expressly provided, the provisions of this Act shall not apply to any of the following transactions: . . . (c) Isolated transactions in which any security issued subsequent to the date of approval of this Act is sold, or offered for sale, subscription, or delivery by the owner thereof, or by his representative solely for the owner's account, such sale or offer for sale, subscription, or delivery not being made in the course of repeated and successive transactions of a like character by such owner for the purpose of engaging in the purchase and sale of securities as a business, such owner or representative not being the issuer or underwriter of, or selling agent for, such security.

H.R. 5480, 73d Cong., 1st Sess. (1933), as passed the Senate with Senate amendments on May 10, 1933, 3 Ellenberger & Maher, item 27, at 66. Taking for granted (without deciding) that the language of section 12(c) limits the

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[18] The Senate passed the conference report (the final version of the 1933 Act) without a similar commentary on the part of the Senate managers. May 22-23, 1933, 77 Cong.Rec. 3879-3888; 4009 (1933), 1 Ellenberger & Maher, item 14, at 3888.

provisions of the Act to initial offerings, the conference report stated that the "substantially similar [civil liability] provisions of the Senate amendment did not apply to any of the securities exempted under the Senate amendment." The conference report thus interpreted section 9 of the Senate's version, which began with the phrase "Every person acquiring any security," as language that "expressly provided" that the limitations of section 12(c) would not have applied. Therefore, we reject Allen's assertion that the Senate's final version displayed any limitation of the civil liability provisions to initial offerings.

The commentary by the House's managers did not mention their version that had limited the application of section 12(2) to fraud in a prospectus or oral communication; rather, the report recognized the Senate version, which applied section 12(2) to the distribution or sale of a security. The Senate version, as the House, had defined "sale" very broadly.[19] And there is no legislative history

[19] The Senate version had defined "sale" or "sell" to include every disposition, or attempt to dispose, of a security or interest in a security for value. For the purposes of the enforcement of this Act only, any security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing, shall be conclusively presumed to constitute a part of the subject of such purchase. "Sale" or "sell" shall also include a contract to sell, an exchange, an attempt to sell or exchange, an option of sale, purchase, or exchange, a solicitation of a sale or an exchange, a subscription or an offer to sell or exchange, directly or by an agent, or by a circular, letter, advertisement, or otherwise. H.R. 5480, 73d Cong., 1st Sess. (1933), section 2(c), as passed the Senate with Senate amendments on May 10, 1933, 3 Ellenberger & Maher, item 27, at 40.

in the Senate that requires the "sale" of a security be limited to initial offerings. In the face of the Senate's broad wording, that civil fraud applies to any sale, the commentary by the House's managers after the joint conference remained silent. Although the legislative history in the House report can be read to focus solely on those offerings pursuant to a registration statement and prospectuses (or in the Third Circuit's words, to initial offerings), the Senate's version of the 1933 Act and the conference report do not confirm the House's comments. Thus, our reading of section 12(2) is not at odds with the legislative history. The legislative history of the 1933 Act does not require the context of the word "prospectus" to have a more narrow definition than that specified in section 2(10).

IV. The impact of Section 12(2) on the 1933 Act Section 17 and the 1934 Act Section 10(b)

The defendants argue that section 12(2) should be viewed in light of corresponding provisions in the 1933 Act and the Securities Exchange Act of 1934 (1934 Act), 48 Stat. 891, 15 U.S.C. §§ 78a et seq.[20] Specifically, "the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen." SEC v. National Sec., Inc., 393 U.S. 453, 466, 89 S.Ct. 564, 571, 21 L.Ed.2d 668 (1969), quoted in Hochfelder, 425 U.S. 185, 206, 96 S.Ct.

[20] As with the 1933 Act, the citations in the opinion will refer to the more familiar sections of the 1934 Act, rather than to the particular sections of the United States Code.

1375, 1387, 47 L.Ed.2d 668.[21] See Pinter, 486 U.S. at 651, 108 S.Ct. at 2080-81 (criticizing an analysis that is divorced from "any reference to the applicable statutory language and from any examination of § 12 in the context of the total statutory scheme."). Accord Rowland, ___ U.S. at ___, 113 S.Ct. at 720. Allen points to the differences between sections 12(2) and 17 of the 1933 Act: Section 12(2) allows a purchaser to obtain rescission in a case involving a "prospectus or oral communication" that contains a false, material fact. Section 17(a) of the 1933 Act, however, makes it unlawful for "any person in the offer or sale of any securities . . . directly or indirectly"

> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

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[21] With regards to the 1934 Act section 10(b) claims, the Supreme Court recently adopted the one and three year statutes of limitations of section 9(e), rather than apply state borrowing principles. Lampf, Pleva, Lipkind v. Gilbertson, ___ U.S. ___, ___, and n. 9, 111 S.Ct. 2773, 2782 and n. 9, 115 L.Ed.2d 321 (1991). The Court noted the effect such an interpretation would have on the "complex web of regulations"; in particular, sections 9, 18 and 20A of the 1934 Act, and section 13 of the 1933 Act. Id., ___ U.S. at ___-___, 111 S.Ct. at 2780-82.

In United States v. Naftalin, 441 U.S. 768, 778-79, 99 S.Ct. 2077, 2084, 60 L.Ed.2d 624 (1979), section 17(a) was the basis of Naftalin's criminal conviction for selling his broker short. He argued successfully to the Eighth Circuit that section 17(a) forbids such fraud only against investors, not brokers. 579 F.2d 444, 447 (1978). The Supreme Court reversed, holding that section 17(a) applied to the entire selling process. 441 U.S. at 772-73, 99 S.Ct. at 2083-84.

Allen notes correctly that section 17 applies to securities sold "directly or indirectly," while section 12(2) applies to a "prospectus or oral communication." Allen argues, by negative implication, that because Congress had intended the scope of section 17 to include initial and secondary sales, by not using the identical words "directly or indirectly" in both sections, Congress intended to confine section 12(2) to initial offerings. Compare Ballay, 925 F.2d at 691 with Barnes v. Osofsky, 373 F.2d 269, 272 (2d Cir.1967) ("In contrast both §§ 12(2) and 17, the antifraud sections of the 1933 Act . . . are not limited to the newly registered securities."). The short rejection of Allen's argument is that Congress, within certain constitutional bounds, can write the statute as Congress desires. In addition, nothing in the Supreme Court's reasoning in Naftalin directs that a broad reading of section 17 dictates a narrow reading of the remainder of the 1933 Act.

Naftalin is first and foremost a teaching in statutory construction. The Supreme Court interpreted the words "offer" and "sale" and concluded that the Congress intended a broad interpretation. 441 U.S. at 773, 99 S.Ct. at 2081-82. "Prospectus" is likewise explicitly defined in

section 2 of the 1933 Act, yet Allen now wishes a narrow interpretation of the word. The Supreme Court also interpreted the language of section 17, "Any person in the offer or sale of any securities . . . directly or indirectly . . . to employ any device, scheme, or artifice to defraud . . . ," as not requiring that "the victim of the fraud be an investor." Id. Likewise, as this opinion discusses above in part II.A, nothing in sections 2(10) or 12(2) requires a distinction between initial offerings and secondary trading.

Next, Naftalin argued that the primary purpose of the 1933 Act was to protect investors, not brokers (resting upon language in the Hochfelder opinion, 425 U.S. 185, 195, 96 S.Ct. 1375, 1382, 47 L.Ed.2d 668). Naftalin, 441 U.S. at 775, 99 S.Ct. at 2082-83. The Supreme Court rejected the argument, concluding that investor protection was not the sole purpose of the 1933 Act; Congress also wanted to encourage a high ethical standard in "every facet of the securities industry." Id., 441 U.S. at 775, 99 S.Ct. at 2082-83, citing SEC v. Capital Gains Bureau, 375 U.S. 180, 186-187, 84 S.Ct. 275, 280, 11 L.Ed.2d 237. The Supreme Court found ample support for this conclusion in the legislative history of section 17(a). In this case, the parties do not dispute that section 12(2) protects purchasers.

Lastly, Naftalin argued that the 1933 Act concerned only initial public offerings and that because his fraud occurred in the aftermarket, only the 1934 Act applied. Naftalin, 441 U.S. at 778, 99 S.Ct. at 2084. The Supreme Court had described the 1933 Act as "designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to

protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing." Hochfelder, 425 U.S. at 195, 96 S.Ct. at 1382. In Naftalin the Supreme Court added that "the 1933 Act was primarily concerned with the regulation of new offerings." Naftalin, 441 U.S. at 777-78, 99 S.Ct. at 2083-84. In the context of section 17(a) of the 1933 Act, however, the Supreme Court carved out an exception to these general statements, concluding that section 17(a) "was meant as a major departure from that limitation. Unlike much of the rest of the [Securities] [A]ct, it was intended to cover any fraudulent scheme in an offer or sale of securities, whether in the course of an initial distribution or in the course of ordinary market trading." Id., 441 U.S. at 778, 99 S.Ct. at 2084.

Allen argues that section 12(2) is not another "major departure" from the general observation that the 1933 Act applies only to initial offerings and the 1934 Act applies to secondary market transactions. We do not share in Allen's enthusiasm. Yes, the Supreme Court assumed that much of the 1933 Act regulates new offerings. In this case Pacific does not challenge that precept. But the Supreme Court viewed section 17 as a major departure from the 1933 Act in the sense that the criminal fraud provision "covered any fraudulent scheme." Naftalin, 441 U.S. at 778, 99 S.Ct. at 2084.[22] Section 12(2) is not that major a

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[22] "This is made abundantly clear both by the statutory language, which makes no distinctions between the two kinds of transactions, and by the [legislative history]." Naftalin, 441 U.S. at 778, 99 S.Ct. at 2084. As this opinion discusses in part II.B, Congress intended the 1933 Act's civil fraud provisions to apply to initial offerings and to secondary trading.

departure – the civil fraud provision does not apply to any fraudulent scheme, only to a particular circumstance of fraud in a prospectus. Such particular articulation by Congress sets section 12(2) apart from any analysis based on general observations. Hochfelder, 425 U.S. at 200 and 207-08, 96 S.Ct. at 1384 and 1387-88.

In addition to sections 12(2) and 17 of the 1933 Act, another corollary civil fraud provision appears in the 1934 Act. In fact, the scope of section 10(b) of the 1934 Act seems to have caused the relatively recent emphasis in section 12(2). In Hochfelder, the Supreme Court was presented with the scope of section 10(b) and the Securities and Exchange Commission rule 10b-5, 17 C.F.R. § 240.10b-5 (1975 (first promulgated in 1942)). They make it unlawful for any person to use any manipulative or deceptive device in the purchase or sale of any security, and provide plaintiffs with a civil damage provision under which to seek redress for material misstatements or omissions of fact.[23] The circuit courts of appeals were split on the necessary showing regarding the misstatement; the standard had ranged from simple negligence to intentional fraud. The Supreme Court chose a standard close to the latter, holding that a private right of action under section 10(b) and rule 10b-5 must show "scienter"; that is, an intent to deceive, manipulate or defraud. Hochfelder, 425 U.S. at 188, 96 S.Ct. at 1378. Because of

[23] Section 10(b) and rule 10b-5 do not expressly provide a civil remedy for a violation. An implied private action was first permitted in Kardon v. National Gypsum Co., 69 F.Supp. 512 (E.D.Pa.1946). By 1976 the Supreme Court had simply assumed the existence of such a right developed by a substantial body of case law. Hochfelder, 425 U.S. at 196-97, 96 S.Ct. at 1382-83.

the scienter requirement defrauded persons would have to look to other federal or state security act provisions to challenge a negligent misstatement or omission of fact.

One of the many reasons the Supreme Court restricted the scope of section 10(b) and rule 10b-5 was the express civil fraud remedies available in the 1933 Act and their corresponding procedural limitations. Id. For example, an action under sections 11 and 12 of the 1933 Act explicitly recite different negligence standards, are limited by a three year statute of limitations period and require the plaintiff to post a bond for costs and attorney fees. Section 10(b) of the 1934 Act or rule 10b-5 promulgated thereunder have no comparable restrictions. The Supreme Court reasoned that to have expanded section 10(b) and rule 10b-5 would have effectively negated many other, more explicit, sections of the 1933 Act. Of course, by closing the door under section 10(b) and rule 10b-5 to persons who have been negligently defrauded, but who cannot prove scienter, the Supreme Court invited all such persons to look to other sections of the securities law. Against this backdrop purchasers alleging fraud, including Pacific in this case, are seeking relief under section 12(2) of the 1933 Act. Nothing in the Supreme Court's decision in Naftalin or Hochfelder, or section 17 of the 1933 Act or section 10(b) of the 1934 Act requires a different interpretation of section 12(2).

Lastly, Allen argues that section 12(2) should be confined to initial offerings for various policy reasons, the majority of which merely rephrase their substantive arguments already discussed. In light of the textual clarity of section 12(2) and the corresponding legislative history, we need not comment further. Pinter, 486 U.S. at 653, 108

S.Ct. at 2081-82; cf. Landreth, 471 U.S. at 694-95 n. 7, 105 S.Ct. at 2307 n. 7.

V. Conclusion

Contrary to the Third Circuit, we hold that section 12(2) applies to initial offerings and secondary market transactions. This comports with the Supreme Court's understanding in Wilko and what the First and Tenth Circuits have already permitted. See supra, part I. Nothing in the structure of the 1933 Act, the context of section 12 or in the legislative history otherwise requires a definition of prospectus different from that stated in section 2(10). Neither section 17 of the 1933 Act nor section 10(b) of the 1934 Act require the contrary. For these reasons, section 12(2) applies to any communication which offers any security for sale or confirms the sale of any security, including the stock purchase agreement in the present case. The order of the district court is REVERSED, and the case is REMANDED for proceedings consistent with the foregoing opinion.

IN THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS EASTERN DIVISION

ALLOYD COMPANY, INC., et al.	)	
Plaintiffs,	)	
	)	
vs.	)	No. 91 C 889
ARTHUR L. GUSTAFSON, et al.	)	
	)	
Defendants.	)	

To: The Honorable Ann C. Williams United States District Judge

REPORT AND RECOMMENDATION

Joan H. Lefkow, Executive Magistrate Judge:

This suit arises out of a Stock Purchase Agreement ("Agreement") pursuant to which plaintiffs, Alloyd Company, Inc. ("New Alloyd"), formerly known as Alloyd Holdings, Inc. ("Holdings"), and Wind Point Partners II ("Wind Point"), agreed to purchase the majority of the stock of Alloyd, Inc. ("Old Alloyd") from defendants Arthur Gustafson, Daniel McLean and Francis Butler. The First Amended Complaint ("complaint"), alleges in count I that defendants made material misrepresentations in connection with the sale of their stock in violation of section 12(2) of the Securities Act of 1933 ("the 1933 Act"), 15 U.S.C. § 771(2), and in count II that defendants breached certain warranty provisions contained in the Agreement.

For the second time,[1] defendants seek summary judgment on all counts of the complaint. The plaintiffs have also renewed their cross motion for summary judgment with respect to liability on the breach of warranty claim (count II).

* * *

ANALYSIS

I. Defendants' Motion Regarding Plaintiffs' Section 12(2) Claim

Defendants raise several arguments in support of their motion for summary judgment with respect to Count I of the Complaint. They argue that despite the Seventh Circuit's recent holding in *Pacific Dunlop Holdings, Inc. v. Allen & Co., Inc.*, 993 F.2d 578 (7th Cir. 1993), section 12(2)[6] does not apply to the type of secondary

[1] The parties previously filed cross motions for summary judgment. On May 29, 1992, Your Honor granted defendants' motion for summary judgment and denied plaintiffs' motion as moot. *Alloyd v. Gustafson*, No. 91 C 889, Mem. Opinion and Order (N.D. Ill. May 29, 1992). On appeal, the Seventh Circuit entered an order remanding the case for reconsideration in light of *Pacific Dunlop Holdings, Inc. v. Allen & Co., Inc.*, 993 F.2d 578 (7th Cir. 1993).

[6] Section 12(2) provides:

Any person who –

(2) offers or sells a security . . . , by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to

market transaction at issue in this case. Additionally, they assert that the plaintiffs have waived their right to any remedy under section 12(2). Finally, with respect to the merits of the section 12(2) claim, defendants contend that plaintiffs have failed to offer any proof of a misrepresentation of material fact and that even if they had, defendants did not know of and could not reasonably have discovered the misrepresentation. Plaintiffs respond that the Seventh Circuit's decision in *Pacific Dunlop* applies section 12(2) to secondary market transactions, like the one at issue, as well as initial offerings. They also assert that they did not waive their rights under section 12(2) and that the record contains evidence supporting each of the elements of their *prima facie* case under section 12(2).

Your Honor, in a May, 1992 opinion regarding the parties' previous cross motions for summary judgment, considered whether the plaintiffs' section 12(2) claim should be dismissed because that section can only be applied to initial offerings. *See Alloyd v. Gustafson*, No. 91 C 889, Mem. Opinion and Order at 10-12 (N.D. Ill. May 29, 1992) ("May, 1992 Opinion"). Noting a division in the case law, the court found the Third Circuit's decision in *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682 (3d

make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him. . . .

Cir. 1991), persuasive. In *Ballay*, the Third Circuit determined that the language and legislative history of section 12(2), as well as its context within the schemes of the 1933 Act and the Securities Exchange Act of 1934 ("the 1934 Act"), established that section 12(2) was only intended to apply to initial offerings of securities and not to secondary transactions. *Id.* at 693. *See Pacific Dunlop*, 1991 U.S. Dist. LEXIS 6748 (N.D. Ill. May 15, 1991). At the time of that opinion, the only court in this district to have considered the issue had followed the reasoning of the *Ballay* court. As Your Honor found, this case involves a secondary market transaction and there is no evidence that it in any way resembled an initial offering.[7] Accordingly, Your Honor granted defendants' motion for summary judgment with respect to plaintiffs' section 12(2) claim and dismissed the remaining count for lack of federal jurisdiction. May, 1992 Opinion at 13.

While this case was on appeal from Your Honor's ruling, the Seventh Circuit reversed Judge Zagel's decision in *Pacific Dunlop*. Our court of appeals expressly rejected the Third Circuit's reasoning and legislative analysis in *Ballay*. Instead, the Seventh Circuit held that section 12(2) includes secondary market transactions. *Pacific Dunlop*, 993 F.2d at 582. After reviewing the case law and performing its own analysis of the provision's legislative

[7] Your Honor's May, 1992 Opinion noted that the legislative history of the 1933 Act suggested that section 12(2) could apply to a redistribution of securities if " 'such redistribution takes on the characteristics of a new offering by reason of the control of the issuer possessed by those responsible for the offering.' " May, 1992 Opinion at 11-12, *citing*, H.R. No. 85, 73rd Cong., 1st Sess. 7 (1933), and *Ballay*, 925 F.2d at 690.

history, the court explained that section 12(2) applies to "any communication which offers any security for sale or confirms the sale of any security." *Id.* at 595. Subsequently, in this case, the Seventh Circuit vacated Your Honor's grant of summary judgment in favor of defendants and remanded the case for further consideration in light of *Pacific Dunlop*.

Defendants' attempt to distinguish *Pacific Dunlop* from the instant action is unconvincing. They argue that the underlying transaction in *Pacific Dunlop*, unlike the one herein, resembled an initial offering in that the sale occurred shortly after an initial offering and the buyers "apparently" did not have access to the company's books and records.[8] Although the company in *Pacific Dunlop* filed a registration statement for an initial public offering of a certain number of shares of common stock, that offering was abandoned when Pacific Dunlop entered into an agreement to purchase 92% of the company's already outstanding stock. There is no indication in the opinion as to when the stock which Pacific Dunlop purchased was actually issued. Moreover, the decision does not establish whether Pacific Dunlop had direct access to the financial records of the company to be purchased. Thus, defendant's grounds for distinguishing *Pacific Dunlop* are premised on unknown facts which should not be presumed to exist. In any event, the Seventh Circuit's

[8] Your Honor previously found that similar factors (passage of time between the transaction and the original issuance of stock, and buyers' access to company's financial records) strongly suggested that transaction was not comparable to an initial offering. May, 1992 Opinion at 12.

holding does not turn on whether the underlying transaction resembled an initial public offering or not. The holding is broadly worded and states that section 12(2) applies to both initial offerings of securities and secondary market transactions. Until our court of appeals or the Supreme Court indicates to the contrary,[9] section 12(2) should be applied to the Agreement at issue herein.

* * *

RECOMMENDATION

For the reasons stated, it is hereby recommended that both plaintiffs' and defendants' motions for summary judgment be denied.

Written objection to any finding of fact, conclusion of law, or the recommendation for disposition of this matter must be filed with the Honorable Ann C. Williams within ten days after service of this Report and Recommendation. *See* Fed. R. Civ. P. 72(b). Failure to object will waive any such issue on appeal.

Respectfully submitted,

/s/ Joan H. Lefkow
JOAN HUMPHREY LEFKOW
United States Magistrate Judge

Dated: March 24, 1994

[9] On March 14, 1994, the Supreme Court granted the defendants' petition for a writ of certiorari regarding the Seventh Circuit's order which vacated Your Honor's entry of summary judgment in their favor. Your Honor previously declined to stay the district court proceedings, including consideration of the parties' renewed motions for summary judgment, while the defendants petitioned for the writ.

STOCK PURCHASE AGREEMENT

THIS STOCK PURCHASE AGREEMENT (the "Agreement") is made and entered into as of December 20, 1989 between Alloyd Holdings, Inc., a Delaware corporation ("Buyer"), and each of Arthur L. Gustafson ("Gustafson"), Daniel R. McLean ("McLean") and Francis I. Butler ("Butler"). Gustafson, McLean and Butler are sometimes referred to herein individually, a "Seller" and collectively, the "Sellers".

RECITALS

As of the date herein, the Sellers own all of the issued and outstanding capital stock of the Alloyd Co., Inc., an Illinois corporation (the "Company"), which stock consists of 98 shares of common stock, without par value (the "Common Stock"). Subject to the terms and conditions set forth in this Agreement, at the Closing (as defined in Section 1D hereof), Buyer desires to acquire from each Seller and each Seller desires to sell to Buyer, the number of shares of Common Stock set forth next to such Seller's name on the signature pages hereto (collectively, the "Purchased Shares").

NOW, THEREFORE, the parties hereto agree as follows:

ARTICLE I

PURCHASE AND SALE OF STOCK

1A. *Stock Purchase.* On and subject to the terms and conditions set forth in this Agreement, at the Closing,

Buyer will purchase from the Sellers and the Sellers will sell, convey and transfer to Buyer all of the Purchased Shares, free and clear of all liens, charges, security interests, options, proxies, voting trusts and agreements and other encumbrances and restrictions.

1B. *Definition of Purchase Price and Estimated Purchase Price: Payments at Closing*

(a) *Purchase Price: Estimated Purchase Price.* The aggregate purchase price (the "Purchase Price") for the Purchased Shares shall be the sum of $18,709,000 *plus* the Adjustment Amount (as defined in Section 1C(a) hereof). The estimated purchase price to be delivered by Buyer to the Sellers pursuant to Section 1B(b) below (the "Estimated Purchase Price") shall be the sum of $18,709,000 *plus* 90% of the Estimated Adjustment Amount (as defined below). Prior to the Closing Date (as defined in Section 1D hereof), the Sellers Spokesperson (as defined in Section 1E hereof) shall prepare and deliver to Buyer (i) a detailed *estimated* consolidated balance sheet for the Company as of December 31, 1989, prepared as if the Closing had occurred as of the close of business on December 31, 1989 (the "Sellers' December Balance Sheet"), and (ii) Sellers' estimate of the Adjustment Amount derived therefrom (the "Estimated Adjustment Amount"). Each of the Sellers' December Balance Sheet and Sellers' calculation of the Estimated Adjustment Amount shall be accompanied by a certificate as to their accuracy and completeness in the form set forth on *Exhibit 1B(a)* hereto.

(b) *Payment of Estimated Purchase Price.* Buyer shall pay to the Sellers at the Closing the Estimated Purchase Price by delivery of:

(i) the aggregate amount of $11,709,000 to the Sellers, in accordance with the individual amounts set forth on the *Consideration Schedule* attached hereto, by wire transfer of immediately available funds to an account or accounts designated by the Sellers to Buyer prior to Closing (collectively, the "Closing Accounts");

(ii) subordinated promissory notes in the aggregate principal amount of $3,000,000 in the form of *Exhibit 1B(b).1 hereto (the "Notes") to the Sellers in the individual principal amounts set forth on the Consideration Schedule;*

(iii) the aggregate amount of $4,000,000 (the "Escrow Fund"), to be contributed by Buyer on behalf of the Sellers in accordance with the individual amounts set forth on the *Consideration Schedule,* to an escrow account established pursuant to an Escrow Agreement among Buyer, Sellers and the LaSalle National Bank, as Escrow Agent, substantially in the form of *Exhibit 1B(b).2* hereto (the "Escrow Agreement"); and

(iv) each Seller's Allocation Percentage (as set forth on the *Consideration Schedule*) of the Estimated Adjustment Amount, by wire transfer of immediately available funds to the Closing Accounts.

1C. *The Adjustment Amount.*

(a) The "Adjustment Amount" means the product of (i) the amount by which Net Book Value (as defined below) as of December 31, 1989 is greater than or less than $7,503,000, as the case may be, and (ii) a fraction, the

numerator of which is the number of days from December 31, 1988 up to and including the Closing Date and the denominator of which is 365. "Net Book Value" means the excess of the Company's Total Assets over the Company's Total Liabilities. "Total Assets" and "Total Liabilities" shall be determined as follows from the Company's audited consolidated balance sheet as of December 31, 1989 (the "1989 Balance Sheet") prepared in accordance with generally accepted accounting principles applied in a manner consistent with those used in preparing the Company's audited consolidated balance sheet as of December 31, 1988 (the "1988 Balance Sheet"). If any item on (or which should be reflected on) the 1988 Balance Sheet is not reflected in accordance with generally accepted accounting principles in effect as of December 31, 1989 (based on authoritative accounting pronouncements and literature), such item will be reflected in computing Net Book Value in accordance with generally accepted accounting principles in effect as of December 31, 1989. In computing Net Book Value for purposes of this Section 1C, the 1989 Balance Sheet (i) shall take into account all accounting entries (including all liabilities and accruals) regardless of their amount and (ii) shall reflect all adjustments and the correction of all errors and omissions; *provided*, that such entries, corrections and adjustments in (i) and (ii) above shall only be taken into account and to the extent that the aggregate net amount of all such entries, corrections and adjustments exceed $25,000, and (iii) shall, subject to the accruals required by Sections 2A(j) and 2A(q) below, be adjusted to exclude and not take into account the effect of the transactions contemplated hereby which result in the determination of

net income after corporate income taxes on a basis which is inconsistent with the determination of such net income for the year ended December 31, 1988, including without limitation, the purchase of Common Stock by the Buyer, the merger of the Company with and into the Buyer, purchase accounting adjustments, changes in accounting method and the expenses related to such transactions, including, but not limited to, bonus payments contemplated by Section 2A(h) hereof.

(b) Buyer shall deliver to the Sellers' Spokesperson no later than March 31, 1990 (i) the 1989 Balance Sheet, and (ii) Buyer's calculation of the Adjustment Amount derived therefrom (the "Buyer Adjustment Amount"). The Buyer Adjustment Amount and the 1989 Balance Sheet delivered by Buyer pursuant to the preceding sentence shall be referred to herein as "Buyer's Determinations". The Sellers' Spokesperson shall have 30 days after the delivery of Buyer's Determinations to deliver to Buyer written notice setting forth the Sellers' Spokesperson's objections to either the 1989 Balance Sheet or the Buyer Adjustment Amount, as the case may be. If the Sellers' Spokesperson sends such written objections to Buyer, any disputes between Buyer and the Sellers' Spokesperson shall be resolved in the manner described in Section 1C(c) below. In the event that the Sellers' Spokesperson fails to object to Buyer's calculation of the Adjustment Amount within the required 30 day period set forth above, the Adjustment Amount shall be equal to the Buyer Adjustment Amount.

(c) Within 30 days after delivery to the Sellers' Spokesperson of the Buyer's Determinations, the Sellers' Spokesperson shall give written notice to Buyer setting

forth in reasonable detail the basis for any such dispute or controversy. Buyer and the Sellers' Spokesperson shall promptly commence good faith negotiations with a view to resolving such dispute or controversy, provided that, if such dispute or controversy shall not be resolved within 10 days after the date of the Sellers' Spokesperson's notice, then Buyer and the Sellers' Spokesperson shall select a mutually acceptable accounting firm of national reputation (the "Neutral Accountants") to resolve such dispute or controversy. If the parties are unable to agree on an accounting firm, then each party shall select one independent accounting firm of national reputation, the two independent accounting firms so selected shall select a third independent accounting firm, and the matter shall be resolved by the third accounting firm so selected. In the event that either party fails to select an independent accounting firm as set forth herein, then the matter shall be resolved by the accounting firm selected by the other party. (If the parties are unable to agree on a mutually acceptable accounting firm and such firm is therefore selected as provided above, such firm shall be the "Neutral Accountants" for purposes hereof.) The Neutral Accountants shall make their determination as to such dispute or controversy within 45 days of their appointment. The Neutral Accountants shall act as experts, not arbitrators, and their determination shall be final, conclusive and binding as between Buyer and Sellers, absent fraud or manifest error. Buyer and the Sellers shall share responsibility for the fees and expenses of the Neutral Accountants in proportion to the degree that the Neutral Accountants have accepted the position of the other party (or parties) in interest. The audited consolidated balance

sheet of the Company as of December 31, 1989 with respect to which the Adjusted Amount is finally determined pursuant to this Section 1C, shall be referred to herein as the "Final Balance Sheet".

(d) If the Adjustment Amount as determined pursuant to Section 1C(b) or 1C(c) above is less than 90% of the Estimated Adjustment Amount (an "Overpayment"), then each Seller shall, within three business days of such determination, pay such Seller's Allocation Percentage (as set forth on the *Consideration Schedule*) of the Overpayment, together with interest on the Overpayment from the Closing Date to the date of payment at a rate of ten percent (10%) per annum (the "Interest Rate") to Buyer by certified or cashier's check.

(e) If the Adjustment Amount as determined pursuant to Section 1C(b) or 1C(c) above is greater than 90% of the Estimated Adjustment Amount (an "Underpayment"), then the Buyer shall, within three business days of such determination, pay to each Seller that Seller's Allocation Percentage (as set forth on the *Consideration Schedule*) of the Underpayment, together with interest on the such amount from the Closing Date to the date of payment at the Interest Rate, by certified or cashier's check.

1D. *Closing*. The closing of the purchase and sale of the Purchased Shares as contemplated by this Agreement (the "Closing") will take place at the offices of Kirkland & Ellis, 200 East Randolph Drive, Chicago, Illinois, at 10:00 a.m. local time on December 22, 1989 or on such other date designated by Buyer upon written notice to the

Sellers' Spokesperson (as hereinafter defined) (the "Closing Date"). Subject to the conditions set forth in this Agreement, at the Closing, (i) the Sellers will deliver to Buyer stock certificates representing the Purchased Shares, duly endorsed for transfer or accompanied by duly executed stock powers and signatures guaranteed, free and clear of all liens, charges, security interests, options, proxies, voting trusts, rights of first refusal and other encumbrances and restrictions, and (ii) Buyer will pay and deliver to the Sellers the Estimated Purchase Price in the manner described in Section 1B(b).

1E. *Sellers' Spokesperson.* The Sellers jointly and severally represent and warrant to Buyer that Buyer shall be entitled to rely exclusively, as being binding upon each of the Sellers, upon any action taken jointly by Arthur L. Gustafson and Daniel R. McLean (jointly, the "Sellers' Spokesperson") with respect to the matters contemplated by this Agreement and upon any document or other paper reasonably believed by Buyer to be genuine and to have been signed by the Sellers' Spokesperson, and Buyer shall not be liable to any such Seller for any action taken or omitted to be taken by Buyer in such reliance.

ARTICLE II

CONDITIONS TO CLOSING

2A. *Conditions to Buyer's Obligation.* The obligation of Buyer to consummate the transactions contemplated by this Agreement is subject to the satisfaction of the following conditions as of the Closing Date:

(a) The representations and warranties set forth in Article IV hereof will be true and correct in all material

respects at and as of the Closing Date as though then made and as though the Closing Date was substituted for the date of this Agreement throughout such representations and warranties (without taking into account any disclosures made by the Sellers to Buyer pursuant to Section 3A(h) hereof), except for representations and warranties expressly made as of a date subsequent to the Closing Date in which case such representations and warranties will be true and correct in all material respects as of such date only;

(b) The Sellers will have performed in all material respects all of the covenants and agreements required to be performed by them under this Agreement at or prior to the Closing Date;

(c) Since the date of the Latest Balance Sheet (as defined in Section 4D), there will have been no material adverse change in and no material adverse event affecting the business, financial condition, operating results, assets, operations or business prospects of the Company or either of the subsidiaries set forth on the *Subsidiaries Schedule* hereto (collectively, the "Subsidiaries" and individually a "Subsidiary") and there will have been no casualty losses or damage to the assets of the Company or any of the Subsidiaries which in the aggregate exceed $50,000, whether or not covered by insurance;

(d) All governmental filings, authorizations and approvals that are required for the consummation of the transactions contemplated hereby will have been duly made and obtained on terms reasonably satisfactory to Buyer;

(e) All consents by third parties that are required for the transfer of ownership of the Purchased Shares to Buyer as contemplated hereby, that are required for the consummation of the transactions contemplated hereby and that are required in order to prevent a breach of or a default under, a termination or modification of, or acceleration of the terms of, any agreement to which the Company or any of the Subsidiaries is a party or to which any of the Company's or any Subsidiary's property is subject (including real estate and equipment leases) which would adversely affect the business of the Company or either Subsidiary as presently conducted will have been obtained on terms reasonably satisfactory to Buyer and appropriate releases, including without limitation, payoff letters, mortgage releases, lien releases, receipts, termination statements, pledged securities and cancelled notes, with respect to all security interests held in the property of the Company and the Subsidiaries and in the Purchased Shares, will have been obtained on terms reasonably satisfactory to Buyer;

(f) No action or proceeding before any court or government body will be pending wherein an unfavorable judgment, decree or order would (i) prevent the carrying out of this Agreement or any of the transactions contemplated hereby, (ii) declare unlawful the transactions contemplated by this Agreement or cause such transactions to be rescinded or (iii) have a material adverse effect on the business, financial condition, operating results, assets, operations or business prospects of the Company or either Subsidiary;

(g) Neither the Federal Trade Commission nor the Department of Justice shall have outstanding any request

for information in connection with the transactions contemplated hereby under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the "HSR Act"). No governmental agency or body shall have instituted or notified either party hereto or any of their affiliates of its intention or threat to institute any suit, action, or legal or administrative proceeding to restrain, enjoin or otherwise question the validity or legality of the transactions contemplated by this Agreement and no order or decree so restraining or enjoining such transactions shall be in effect. All waiting periods of extensions thereof provided for in Title II of the HSR Act with respect to the transactions contemplated hereby shall have expired;

(h) The Company will have entered into a Bonus Agreement with each of Daniel R. McLean and Francis I. Butler (collectively, the "Managers") in form and substance reasonably satisfactory to Buyer, and on or prior to the Closing Date the Company shall have paid to each of the Managers the bonus amounts required to be paid pursuant to such Manager's Bonus Agreement;

(i) All agreements, written or oral, among stockholders of the Company or between the Company and any stockholder or group of stockholders of the Company (including, without limitation, that certain Memorandum of Understanding dated May 5, 1989, among the Company and each of the Sellers (the "Memorandum of Understanding")) shall have been terminated by a writing in form and substance reasonably satisfactory to Buyer, in each case without any further liability or obligation on the part of the Company;

(j) On or prior to the Closing Date, (i) the Sellers shall have fully reimbursed the Company for any of the Transaction Expenses (as defined in Section 7D hereof) charged to the Company or any of the Subsidiaries or the Company shall have fully accrued for all Transaction Expenses incurred on or prior to the Closing Date, and (ii) each of the Sellers shall have fully reimbursed the Company for (x) the amount, if any, of such Seller's indebtedness to the Company (with respect to each Seller, the "Seller Debt"), and (v) the book value of any personal property distributed to such Seller by the Company pursuant to Section 2B(g);

(k) Arthur L. Gustafson shall have entered into a non-competition agreement with the Buyer in the form of *Exhibit 2A(k)* hereto (the "Non-Compete Agreement"), and as of the Closing Date the Non-Compete Agreement will be in full force and effect with respect to the Arthur L. Gustafson;

(l) At least one business day prior to Closing, each of the Managers will have entered into an Executive Stock Agreement and an Executive Employment Agreement with the Buyer in substantially the form set forth in *Exhibit 2A(1)* hereto, and as of the Closing Date such agreements (respectively, the "Executive Stock Agreements" and the "Executive Employment Agreements") shall be in full force and effect with respect to the Managers;

(m) Buyer's Lenders (as defined below) shall have provided to Buyer or its designee sufficient debt financing necessary to consummate the transactions contemplated by this Agreement on terms and conditions satisfactory to Buyer;

(n) Buyer will have received from Sellers' counsel, Vedder, Price, Kaufman & Kammholz, their opinion with respect to the matters set forth in *Exhibit 2A(n)* attached hereto, addressed to Buyer and The Prudential Insurance Company of America and the other institutions and entities providing debt financing to Buyer to consummate the transactions contemplated hereby (collectively, "Buyer's Lenders"), dated the date of the Closing and in form and substance reasonably satisfactory to Buyer and Buyer's Lenders;

(o) At the Closing, Sellers will have delivered to Buyer all of the following:

(i) A certificate signed by the Sellers in the form set forth in *Exhibit 2A(o)* attached hereto, dated the date of the Closing, stating that the preconditions specified in subsections (a) through (j) hereof, inclusive, and (q) have been satisfied;

(ii) Copies of all necessary third party and governmental consents, releases, approvals and filings required in order to effect the transactions contemplated by this Agreement;

(iii) Certificates representing the Purchased Shares, duly endorsed for transfer or accompanied by duly executed stock powers (with signatures guaranteed), together with evidence of payment of all applicable stock

transfer taxes. The Company's minute books, stock transfer records, corporate seals and other materials related to the Company's and the Subsidiaries' corporate administration and record keeping shall be at the Company's principal place of business;

(iv) Resignations, effective as of the Closing Date, from the officers and directors of the Company and each of the Subsidiaries requested by the Buyer;

(v) Good standing certificates of the Company from the State of Illinois, of each of the Subsidiaries from their respective states of incorporation, and of the Company and each of the Subsidiaries in the states where each is qualified to do business as a foreign corporation, all dated as of a date within five days prior to the Closing;

(vi) Articles of Incorporation of the Company and all amendments thereto certified, as of a date within ten business days of the Closing, by the State of Illinois and By-laws of the Company and all amendments thereto certified by its Secretary;

(vii) A Certificate of Incumbency covering all officers of the Company executing documents in connection with the transactions contemplated hereby certified by the Secretary of the Company;

(viii) A *Seller Debt Schedule* setting forth, with respect to each Seller, all amounts added to (including, without limitation, all personal expenses of each Seller charged to the Company's account) and/or subtracted to the Seller Debt of such Seller since the date of the Latest Balance Sheet;

(ix) Evidence of title insurance as follows:

(A) With respect to each parcel of real estate identified as owned by the Company or either Subsidiary on the *Owned Property Schedule*, Sellers shall have procedure an ALTA Form B - 1987 Owner's Policy of Title Insurance [or equivalent policy acceptable to the Buyer if the real property is located in a state in which an ALTA Form B - 1987 Owner's Policy of Title Insurance is not available] issued by Lawyers Title Insurance Corporation, in an amount equal to the fair market value of such real property (including all improvements located thereof, insuring title to such real property to be in Buyer of the Closing (subject only to the title exceptions set forth on the *Permitted Encumbrances Schedule*);

(B) Each title insurance policy delivered under Section 2A(o)(ix)(A) shall (i) insure title to the real property and all recorded easements benefitting such real property, (ii) contain an "extended coverage endorsement" insuring over the general exceptions contained customarily in such policies, (iii) contain an ALTA Zoning Endorsement 3.1 (or equivalent), (iv) contain an endorsement insuring that the real property described in the title insurance policy is the same real estate as shown on the survey delivered with respect to such property, (v) contain an endorsement insuring that each street adjacent to the real property is a public street and that there is direct and unencumbered pedestrian and vehicular access to such street from the real property, (vi) if the real property consists of more than one record parcel, contain a "contiguity" endorsement insuring that all of

the record parcels are contiguous to one another, and (vii) contain a "non-imputation" endorsement to the effect that title defects known to the officers, directors and stockholders of the owner prior to the Closing shall not be deemed "facts known to the insured" for purposes of the policy (if available);

(x) With respect to each parcel of real property identified as owned by the Company or either Subsidiary on the *Owned Property Schedule*, and as to which a title insurance policy is to be procured pursuant to Section 2A(o)(ix) above, Sellers shall have procedure in preparation for the Closing a current survey of the real property certified to the Buyer, prepared by a licensed surveyor and conforming to current ALTA Minimum Detail Requirements for Land Title Surveys, dated no later than thirty (30) days prior to the Closing Date, disclosing the location of all improvements, easements, party walls, sidewalks, roadway, utility lines and other matters customarily shown on such surveys and showing access affirmatively to public streets and roads (the "Survey"). Any survey defect or encroachment from or onto the real property, except for those disclosed on the *Permitted Encumbrances Schedule* attached hereto, will have been cured or insured over prior to the Closing Date;

(xi) a power of attorney, jointly executed by each of the Sellers, appointing and empowering the Sellers' Spokesperson and copies of all other documentation relating to the appointment of the Sellers' Spokesperson, all in form and substance reasonably satisfactory to Buyer; and

(xii) such other documents or instruments as Buyer reasonably requests not later than three days prior to the date of the Closing to effect the transactions contemplated hereby;

(p) The Sellers shall have entered into a Subordination Agreement with Buyer's Lenders substantially in the form of Exhibit 2A(p) attached hereto (the "Subordination Agreement") and as of the Closing Date the Subordination Agreement will be in full force and effect with respect to the Sellers; and

(q) On or prior to the Closing Date, the Company shall have paid or accrued all sales commissions and bonuses payable to the Company's and the Subsidiaries' sales employees and the Company shall have either paid or accrued the bonus amount payable to William Lord pursuant to the Memorandum of Understanding.

All proceedings to be taken by Sellers and the Company in connection with the consummation of the closing and other transactions contemplated hereby and all certificates, opinions, instruments and other documents required to effect the transactions contemplated hereby reasonably requested by Buyer will be reasonably satisfactory in form and substance to Buyer. Any condition specified in this Section 2A may be waived in writing by Buyer.

2B. *Conditions to Sellers' Obligation*. The obligation of the Sellers to consummate the transactions contemplated by this Agreement is subject to the satisfaction of the following conditions as of the Closing Date:

(a) The representations and warranties set forth in Article V hereof will be true and correct at and as of the Closing Date as though then made and as though the Closing Date was substituted for the date of this Agreement throughout such representations and warranties;

(b) Buyer will have performed all the covenants and agreements required to be performed by it under this Agreement at or prior to the Closing Date;

(c) Neither the Federal Trade Commission nor the Department of Justice shall have outstanding any request for information in connection with the transaction contemplated hereby under the HSR Act. No governmental agency or body shall have instituted or notified either party hereto or any of their affiliates of its intention or threat to institute any suit, action, or legal or administrative proceeding to restrain, enjoin or otherwise question the validity or legality of the transactions contemplated by this Agreement and no order or decree so restraining or enjoining such transactions shall be in effect. All waiting periods or extensions thereof provided for in Title II of the HSR Act with respect to the transactions contemplated hereby shall have expired;

(d) Sellers will have received from Buyer's counsel, Kirkland & Ellis, their opinion with respect to the matters set forth in *Exhibit 2B(d)* attached hereto, addressed to the Sellers, dated the date of the Closing and in form and substance reasonably satisfactory to Sellers;

(e) At the Closing Buyer will have delivered to the Sellers:

(i) a Buyer's certificate in the form set forth in *Exhibit 2B(e)* attached hereto, dated the date of the Closing, stating that the preconditions specified in subsections (a) through (c) hereof have been satisfied;

(ii) a long form good standing certificate of Buyer issued by the Secretary of State of the State of Delaware, dated as of a date within five days prior to the Closing Date;

(iii) the Certificate of Incorporation of Buyer, as of a date within 10 business days of the Closing Date, certified by the Secretary of State of the State of Delaware and Bylaws of the Buyer certified by its Secretary; and

(iv) a certificate of Incumbency covering all officers of the Buyer executing this Agreement or any of the other agreements contemplated hereby certified by Buyer's Secretary; and

(v) such other documents or instruments as Sellers reasonably request not later than three days prior to the Closing Date to effect the transactions contemplated hereby;

(f) Buyer will have paid the Estimated Purchase Price to the Sellers, will have delivered the Notes to the Sellers and will have executed the Escrow Agreement and delivered the Escrow Fund to the Escrow Agent, all as provided in Section 1B(b);

(g) The Company will have distributed to the Sellers the items of personal property set forth on the *Transferred Assets Schedule* attached hereto, and shall have paid each of the Sellers the amount, if any, by which the

sum of the book value of the personal property distributed to such Seller as provided above plus the amount of the Company's obligations to such Seller (including, without limitation, obligations for accrued salary and bonus) exceeds the amount of such Seller's Seller Debt; and

(h) The Buyer shall have executed the Non-Compete Agreement and shall have paid the consideration to Arthur Gustafson as provided therein.

All proceedings to be taken by Buyer in connection with the consummation of the Closing and the other transactions contemplated hereby and all certificates, opinions, instruments and other documents required to be delivered by Buyer to effect the transactions contemplated hereby reasonably required by the Sellers' Spokesperson will be reasonably satisfactory in form and substance to the Sellers' Spokesperson. Any condition specified in this Section 2B may be waived in writing by the Sellers' Spokesperson.

ARTICLE III

COVENANTS OF THE SELLERS PRIOR TO CLOSING AND OF BUYER PRIOR TO CLOSING

3A. *Affirmative Covenants of Seller.* Prior to the Closing Date, the Sellers will, and will cause the Company and each of the Subsidiaries to:

(a) conduct the Company's and the Subsidiaries' operations only in the usual and ordinary course of business in accordance with past practices, except as otherwise expressly contemplated by this Agreement;

(b) keep in full force and effect the Company's and the Subsidiaries' corporate existence and all rights and franchises pertaining to the Company's and Subsidiaries' business;

(c) use best efforts (consistent with sound business judgment) to retain the Company's and the Subsidiaries' employees and preserve the Company's and the Subsidiaries' present business relationships;

(d) maintain the Company's and the Subsidiaries' assets in customary repair, order and condition, ordinary wear and tear excepted, and maintain insurance comparable to that in effect as of the date of the Latest Balance Sheet (as defined in Section 4D hereof);

(e) maintain the Company's and the Subsidiaries' books, accounts and records in accordance with past custom and practice as used in the preparation of the financial statements described in Section 4D hereof (except for the regular year-end adjustments which in the aggregate are not material);

(f) permit Buyer and its employees, agents, accounting and legal representatives and potential investors and lenders (and such lenders' audit staff) and their representatives to have free and full access during normal business hours to the employees, properties, books, records, invoices, contracts, leases, key personnel, facilities and equipment of Company and each of the Subsidiaries, wherever located, in order that Buyer may have full opportunity to make such continuing investigation of the company and the Subsidiaries as it in its sole discretion shall deem necessary or desirable in connection with the transactions contemplated hereby. Without limiting the

generality of the foregoing, Seller will afford to the environmental consulting firm of Geraghty & Miller Engineers, Inc. ("Geraghty & Miller") free and full access at all reasonable times and upon reasonable notice to the officers, employees, properties, books and records of the Company and each of the Subsidiaries in order that Geraghty & Miller shall be able to conduct a comprehensive environmental due-diligence audit of the Company and the Subsidiaries;

(g) use best efforts (consistent with sound business judgment) to obtain all consents and approvals necessary or desirable to consummate the transactions contemplated hereby and to cause the other conditions to Buyer's obligation to close to be satisfied; and

(h) promptly inform Buyer in writing of any matters which become known to any Seller which would cause representations and warranties contained in Article IV hereof to be untrue in any material respect as of the date of this Agreement or as of the Closing Date.

3B. *Negative Covenants of the Sellers.* Except as otherwise specifically contemplated herein, prior to the Closing Date, without the prior written consent of Buyer, the Sellers will not, and will not permit the Company or the Subsidiaries to:

(a) make any amendments to the Company's or either Subsidiary's Articles of Incorporation or By-laws;

(b) redeem any of the Company's or either Subsidiary's capital stock, declare or pay any dividend or distribution on the Company's or either Subsidiary's capital stock or permit a withdrawal of funds or other assets

from the Company, except as otherwise expressly contemplated by this Agreement;

(c) directly or indirectly, solicit, encourage or initiate any discussion with, or negotiate or otherwise deal with or provide any information to, any Person other than Buyer and Buyer's agents and accounting and legal representatives, concerning any disposition or sale of the Purchased Shares, the Company or any of the Subsidiaries (including pursuant to sale of assets, merger or other business combination) or enter into any agreement concerning any disposition or sale of the Purchased Shares, the Company or any of the Subsidiaries (including pursuant to sale of assets, merger or other business combination), other than with respect to the transactions contemplated by this Agreement *provided* that the foregoing shall not prohibit providing information in the ordinary course of business or providing information as required by applicable law. In the event that the Sellers become legally compelled to disclose any such information, Sellers will provide Buyer with prompt notice before such disclosure so that Buyer may seek a protective order or other appropriate remedy or waive compliance with the provisions of this Agreement or both. In the event that such protective order or other remedy is not obtained, or that the Buyer waives compliance with the provisions of this Agreement, Sellers will furnish only that portion of the information which they are advised by opinion of counsel (such choice of counsel to be reasonably satisfactory to Buyer) is legally required and will exercise their best efforts to obtain a protective order or other reliable assurance that confidential treatment will be accorded the disclosed information;

(d) grant any increase in salary or otherwise increase the compensation payable to any officer, partner, employee or agent, except wage or salary increases as required by pre-existing contracts or compensation policies which are in the ordinary course of business consistent with past practices;

(e) enter into, amend or terminate any employment or labor agreement or any employee pension benefit plan or any employee welfare benefit plan (as described in Section 4S);

(f) terminate or modify any contract or any government license, permit or other authorization other than in the ordinary course of business;

(g) enter into any contract not in the ordinary course of business or any contract which requires aggregate payments in excess of $50,000, other than purchase orders or sale orders entered into in the ordinary course of business on the standard forms set forth on *Exhibit 4M* attached hereto;

(h) institute any material change in method of production, purchase, sale, lease, management, operation or accounting;

(i) take or omit to take any action which could be reasonably anticipated to have a materially adverse effect upon the business, financial condition, operating results, assets, operations or business prospects of the Company or either Subsidiary; or

(j) except as otherwise expressly contemplated by this Agreement, take any action that would require disclosure pursuant to Section 3A(h) hereof.

The term "Person", as used throughout this Agreement, means an individual, a partnership, a corporation, an association, a joint venture, an unincorporated organization or a governmental entity, or any department, agency or political subdivision thereof.

3C. *Affirmative Covenants of Buyer.* Prior to the Closing Date, Buyer will:

(a) Promptly inform the Sellers' Spokesperson in writing of any variances from the representations and warranties contained in Article V hereof which become known to Buyer;

(b) Use best efforts (consistent with sound business judgment) to obtain all consents and approvals necessary or desirable to consummate the transactions contemplated hereby and to cause the other conditions to the Sellers' obligations to be satisfied; and

(c) Use best efforts (consistent with sound business judgment) to obtain sufficient financing necessary to consummate the transactions contemplated by this Agreement.

ARTICLE IV

REPRESENTATIONS AND WARRANTIES OF THE SELLERS

As an inducement to Buyer to enter into this Agreement, the Sellers jointly and severally (but severally only with respect to the representations and warranties set forth in Section 4B(ii)) hereby represent and warrant to Buyer that:

4A. *Organization and Corporate Power.* The Company is a corporation duly organized, validly existing and in good standing under the laws of the State of Illinois. Each Subsidiary is a corporation duly organized, validly existing and in good standing under the respective laws of the state of its incorporation. Each of the Company and the Subsidiaries are qualified to do business as a foreign corporation in all other jurisdictions in which the character of their respective properties or the nature of their respective activities require them to do so qualified, except where the failure to be so qualified will not result in material Losses (as defined in Section 7B hereof) to the Company and the Subsidiaries taken as a whole (which Losses shall be deemed "material" for purposes of this Section 4A only in the event and then only to the extent such Losses in the agreements exceed $10,000.) Neither the Company nor the Subsidiaries are liable for any taxes or penalties resulting from the failure to qualify to do business as a foreign corporation in any jurisdiction. The Company and the Subsidiaries have all requisite power and authority and all authorizations, licenses and permits necessary to own and operate their respective properties and to carry on their respective business as now conducted. Copies of the Company's and the Subsidiaries' respective Articles or Certificate of Incorporation and By-laws have been furnished to Buyer and reflect all amendments made thereto at any time prior to the date of this Agreement and are correct and complete in all respects.

4B. *Capital Stock, etc.*

(i) The authorized capital stock of the Company consists of 500 shares of common stock, no par value per share, 98 shares of which are issued and outstanding. The

authorized capital stock of each of the Subsidiaries, the number of shares issued and outstanding thereof and the ownership thereof are all as set forth on the *Subsidiaries Schedule*. Except as set forth on the *Encumbrances Schedule* attached hereto, the Company owns all of the issued and outstanding capital stock of each Subsidiary free and clear of any security interest, claim, lien, pledge, encumbrance or charge. Except as set forth on the *Seller Encumbrances Schedule* attached hereto, none of the outstanding capital stock of the Company or either Subsidiary is subject to any agreement, voting trust, proxy or other arrangement or restriction whatsoever. All of the issued and outstanding capital stock of the Company (collectively, the "Company Stock") and each of the Subsidiaries has been duly authorized and is validly issued, fully paid and nonassessable. There are no rights, subscriptions, warrants, options, conversion rights or agreements of any kind outstanding to purchase or otherwise acquire any shares of capital stock of the Company or either Subsidiary or to acquire any securities or obligations of any kind convertible into or exchangeable for any shares of capital stock of the Company or either subsidiary. There are no agreements or other obligations (contingent or otherwise) which may require the Company or either of the Subsidiaries to repurchase or otherwise acquire any shares of their capital stock.

(ii) Except as set forth on the *Seller Encumbrances Schedule*, Arthur L. Gustafson owns beneficially and of record 83 shares of the Company Stock, Daniel R. McLean owns beneficially and of record 10 shares of the Company Stock and Francis I. Butler owns beneficially and of record five shares of the Company

Stock, and collectively the Sellers own beneficially and of record all of the issued and outstanding shares of Company Stock, in each case free and clear of any security interest, claim, lien, pledge, encumbrance or charge.

4C. *Authorization: No Breach.* This Agreement and the Escrow Agreement have been duly executed and delivered by the Sellers, and this Agreement constitutes a valid and binding obligation of the Sellers, enforceable in accordance with its terms, except as may be limited by applicable debtor relief laws and general principles of equity. Except as set forth on the *Authorizations Schedule* attached hereto, the execution, delivery and performance of this Agreement by the Sellers and the consummation of the transactions contemplated hereby do not and will not (i) conflict with or result in any breach of any of the provisions of, (ii) constitute a default under, (iii) result in a violation of, (iv) given any third party the right to terminate or to accelerate any obligation under, (v) result in the creation of any lien, security interest, charge or encumbrance upon any of the capital stock or equity interests or any assets of the Company or either Subsidiary, or (vi) require any authorization, consent, approval, exemption or other action by or notice to any court or other governmental body, under the provisions of the Articles or Certificate of Incorporation or By-laws of the Company or either Subsidiary or any indenture, mortgage, lease, loan agreement or other agreement or instrument to which the Company, either Subsidiary or the Sellers are bound or affected by any law, statute, rule or regulation to which the Company, either Subsidiary or the Sellers are subject.

4D. *Financial Statements.* Sellers have furnished Buyer with copies of (i) the 1988 Balance Sheet (including a consolidated budget for the fiscal year beginning January 1, 1989) and the Company's consolidated audited balance sheets as of December 31, 1987, December 31, 1986, December 31, 1985 and December 31, 1984 and the related audited consolidated statements of income and sources and applications of funds for the years then ended and (ii) the Company's consolidated unaudited balance sheet and related statements of income for the ten months ended October 31, 1989 (such consolidated unaudited balance sheet being referred to herein as the "Latest Balance Sheet"). The foregoing financial statements have been prepared in accordance with generally accepted accounting principles consistently applied throughout the periods indicated therein, subject, in the case of interim financials, to normal, year-end adjustments (which in the aggregate will not be material) and those adjustments set forth on the notes to the Latest Balance Sheet, which is attached hereto and shall be deemed to be the *Financial Statements Schedule* have been based upon the information contained in the Company's books and records, present fairly on a consolidated basis the Company's financial condition and related results of operations as of the times and for the periods referred to therein and, except for the Latest Balance Sheet, have been audited by a certified public accountant. The Company's books of account and financial records fairly reflect the Company's income, expenses and liabilities.

4E. *Absence of Undisclosed Liabilities.* Neither the Company nor either Subsidiary has any obligation or

liability (whether accrued, absolute, contingent, unliquidated or otherwise, whether or not known to the Sellers, the Company or either Subsidiary, whether due or to become due and regardless of when or by whom asserted) arising out of transactions entered into at or prior to the date hereof, or any action or inaction at or prior to the date hereof, or any state of facts existing at or prior to the date hereof, including taxes with respect to or based upon transactions or events occurring on or before the date hereof, except (i) obligations under contracts or commitments described on the *Contracts Schedule* attached hereto or under contracts and commitments entered into in the ordinary course of business which are not required to be disclosed thereon (but not liabilities for breaches thereof), (ii) liabilities reflected on the Latest Balance Sheet, (iii) liabilities which have arisen after the date of the Latest Balance Sheet in the ordinary course of business (none of which is a liability for breach of contract, breach of warranty, tort, infringement, claim or lawsuit) including, without limitation, accrued but unpaid taxes and accrued but unpaid annual license fees and franchise taxes and (iv) liabilities otherwise expressly disclosed in or contemplated by this Agreement or the Schedules attached hereto.

4F. *Inventories*. The inventories, net of reserves, to the extent of the values shown on the Final Balance Sheet, will consist of a quality and quantity usable and saleable in the ordinary course of business, will be merchantable and suited for the purpose for which they were manufactured and will not be damaged, defective or obsolete.

4G. *Accounts Receivable*. Except for matters of the type described in (i), (ii) and (iii) below with respect to

the accounts receivable of the Company and the Subsidiaries which in the aggregate with respect to all such matters do not and will not exceed $50,000, (i) the accounts receivable of the Company and the Subsidiaries to be reflected on the Final Balance Sheet will be valid receivables and will be collected on or before June 29, 1990 at the aggregate face amount thereof (subject to no counterclaims or offset), (ii) as of December 31, 1989, no Person or entity will have any lien on such receivables or any part thereof, and (iii) no agreements for deduction, free goods, discounts or other deferred price or quantity adjustments will have been made with respect to such receivable.

4H. *Subsidiaries*. Except for the Subsidiaries set forth on the attached *Subsidiaries Schedule*, neither the Company nor either Subsidiary owns, directly or indirectly, any stock, partnership interest, joint venture interest or other security or interest in any other corporation, organization or entity. The *Subsidiaries Schedule* fully and accurately sets forth the capitalization of each Subsidiary described therein as contemplated by Section 4A.

4I. *No Material Adverse Changes*. Since the date of the Latest Balance Sheet, there has been no material adverse change in or any material adverse event affecting the business, financial condition, operating results, assets, operations or business prospects of the Company or either of the Subsidiaries.

4J. *Absence of Certain Developments*.

(a) Except as set forth in the *Developments Schedule* attached hereto, since the date of the Latest Balance

Sheet, neither the Company nor any of the Subsidiaries have:

(i) except as otherwise expressly contemplated by this Agreement, redeemed or purchased, directly or indirectly, any shares of their capital stock or declared or paid any dividends or distributions with respect to any shares of their capital stock or permitted any other withdrawal or distribution of their funds or other assets other than for normal and reasonable salaries and the payment of their normal expenses in accordance with past practices;

(ii) issued, sold or transferred any of their equity securities, securities convertible into their equity securities or warrants, options or other rights to acquire their equity securities or partnership equity interests, or any bonds or other securities issued by them;

(iii) discharged or satisfied any lien or encumbrance or paid any liability, other than current liabilities paid in the ordinary course of business;

(iv) mortgages, pledged or subjected to any lien, charge or any other encumbrance, any of their properties or assets, except liens for current property taxes not yet due and payable;

(v) except as otherwise expressly contemplated by this Agreement, sold, assigned or transferred any of their tangible assets, except in the ordinary course of business, or cancelled without fair consideration any debts or claims owing to or held by them;

(vi) sold, assigned, transferred or otherwise encumbered any of Company's or either Subsidiary's: (A)

patents, patent applications or patent disclosures or the inventions contained therein, any reissued, continuation, continuation-in-part, division, extension, or reexamination of the foregoing (collectively, the "Patents"); (B) trademarks, service marks, trade dress, trade names or corporate names or the goodwill of the business in connection with which any such mark, name or trade dress is used (collectively, the "Trademarks"); (C) copyrights, registered or unregistered, statutory or common law, in or to any of Company's works (the "Copyrights"); (D) mask works (the "Mask Works"); (E) trade secrets and confidential business information (including ideas, formulas, compositions or inventions, whether or not patentable and whether or not reduced to practice), know-how, manufacturing and production processes and techniques, research and development information, drawings, specifications, designs, plans, proposals, technical data or customer and supplier lists (collectively, the "Confidential Information"); (F) other proprietary rights or any income, royalties, damages or payments due or payable at the Closing Date or thereafter in connection with the any of foregoing; or (G) licenses or other agreements regarding any of the foregoing (collectively, the "Proprietary Rights").

(vii) except as otherwise expressly contemplated by this Agreement, made or granted any bonus or any wage or salary increase to any employee or group of employees, or made or granted any increase in any employee benefit plan or arrangement, or amended or terminated any existing employee benefit plan or arrangement or adopted any new employee benefit plan or arrangement;

(viii) except as set forth on the *Capital Expenditures and Commitments Schedule* attached hereto, made capital expenditures or commitments therefor which in the aggregate exceed $10,000, other than commitments reflected in the Latest Balance Sheet;

(ix) except as set forth on the *Capital Expenditures and Commitments Schedule*, incurred any indebtedness for borrowed money or incurred or become subject to any liability, except current liabilities in the ordinary course of business;

(x) made any loans or advance to, or guarantees for the benefit of, any Person (other than advances to employees in the ordinary course of business);

(xi) suffered any extraordinary losses or waived any rights of material value, whether or not in the ordinary course of business or consistent with past practice;

(xii) entered into any other material transaction except as otherwise expressly contemplated by this Agreement;

(xiii) made charitable contributions or pledges which in the aggregate $10,000; or

(xiv) suffered any damage, destruction or casualty loss to their tangible assets which in the aggregate exceed $10,000, whether or not covered by insurance.

(b) No officer, director, partner, employee or agent of the Company or either Subsidiary has been or is authorized to make or receive, and Sellers do not know of the Company, either of the Subsidiaries or any of their respective officers, directors, partners, employees or

agents making or receiving, any bribe, kickback payment or other illegal payment at any time.

4K. *Title to Property*

(a) The Company and/or one of the Subsidiaries holds good and marketable title to the real property identified as owned by the Company or such Subsidiary on the *Owned Property Schedule*, and such title is subject only to (i) utility liens, (ii) liens for taxes not yet due and payable, (iii) covenants, conditions and restrictions of record which are not violated in any material respect by existing uses or improvements and which do not interfere with the current use and/or occupancy of the real estate nor impair or adversely affect the merchantability thereof and (iv) matters shown as title exceptions on the *Permitted Encumbrances Schedule* or the *Encumbrances Schedule*, as the case may be.

(b) Except as set forth on the *Leased Property Schedule* attached hereto, the leases relating to the property identified as leased by the Company or one of the Subsidiaries on the *Leased Property Schedule* are in full force and effect and the Company or such Subsidiary holds a valid and existing leasehold interest under each such lease. Sellers have made available to Buyer complete and accurate copies of each of the leases relating to real property identified as leased by the Company or one of the Subsidiaries on the *Leased Property Schedule* and one of such leases has been modified, except to the extent that such modifications are disclosed by the copies delivered to Buyer. The Company is not in default under, nor is there any default by the lessor under, nor does any Person have the right to terminate, accelerate performance under or

otherwise modify (including upon the giving of notice or the passage of time), any of such leases.

(c) The property described on the *Owned Property Schedule* and the *Leased Property Schedule* attached hereto constitute all of the real property owned, leased, used or occupied by the Company or one of the Subsidiaries.

(d) Except for the encumbrances (i) reflected on the Latest Balance Sheet, (ii) relating to current taxes not yet due and payable, (iii) set forth on the *Owned Property Schedule* or the *Encumbrance Schedule*, the Company owns good and marketable title, free and clear of all liens, charges, security interests and encumbrances, to all of the personal property and assets shown on the Latest Balance Sheet, or acquired thereafter or located on the Company's or either Subsidiary's premises.

(e) The buildings, improvements, fixtures, machinery, equipment, and other tangible assets of the Company and the Subsidiaries (whether owned or leased) located on the real property listed on the *Owned Property Schedule* or the *Leased Property Schedule* attached hereto are, except for ordinary wear and tear, in good condition and repair and are usable in the ordinary course of business. The Company or one of the Subsidiaries own or lease under valid leases all buildings and all such machinery, equipment and other tangible assets necessary to conduct their respective businesses in conformity with past practices, the Company and the Subsidiaries have good and marketable title to all such assets owned by them, and, all such assets have been installed and maintained in compliance with all applicable laws, regulations and ordinances, except where noncompliance with such laws,

regulations and ordinances will not result in material Losses to the Company and the Subsidiaries (which Losses shall be deemed "material" for purposes of this Section 4K(e) only in the event and then only to the extent that such Losses in the aggregate exceed $30,000).

(f)(i) Except as set forth on the *Compliance Schedule* attached hereto, neither the Company nor either Subsidiary is in violation of any applicable health, safety or zoning ordinance relating to the operation of the real property listed on the *Owned Property Schedule* or the *Leased Property Schedule* attached hereto, other than the Company's owned real property located in DeKalb, Illinois (the "DeKalb Property"). Except as set forth on the *Compliance Schedule*, neither the Sellers, the Company, nor either Subsidiary have received any notice of any violation of any health, safety or zoning law, regulation or requirement within twelve months prior to the date hereof relating to the operation of the real property listed on the *Owned Property Schedule* or the *Leased Property Schedule* attached hereto. None of the real property listed on the *Owned Property Schedule* and the *Leased Property Schedule* attached hereto, other than the DeKalb Property, is classified as a "permitted non-conforming use" or "permitted non-conforming structure" under applicable zoning ordinances.

(ii) To the best knowledge of the Sellers, neither the Company nor either of the Subsidiaries are in violation of any applicable zoning ordinance relating to the operation of the DeKalb Property. Except as set forth on the *Compliance Schedule*, neither the Company nor any of the Subsidiaries are in violation of any applicable health or safety ordinance relating to the operation of the

DeKalb Property. To the best knowledge of the Sellers, none of the DeKalb Property is classified as a "permitted non-conforming use" or "permitted non-conforming structure" under applicable zoning ordinances.

(g) Except as disclosed on the *Owned Property Schedule* or the *Leased Property Schedule*, as the case may be, the real property listed on the *Owned Property Schedule* and the *Leased Property Schedule* attached hereto has unqualified access by legal, valid and irrevocable easements to public roads and to all utilities, including electricity, sanitary and storm sewers, portable water, natural gas and other utilities used in the operation of the Company's and the Subsidiaries' respective businesses.

(h) Neither the Company, any of the Subsidiaries nor the Sellers have received any notice of the existence of any pending or contemplated condemnation or eminent domain proceeding with respect to the real property listed on the *Owned Property Schedule* or the *Leased Property Schedule* attached hereto within the three years prior to the date hereof.

4L. *Tax Matters*. The Company and the Subsidiaries have timely filed all federal, foreign, state, county and local income, excise, property and other tax returns which are required to be filed by them; all such returns are true and correct; all taxes of any kind (including any interest or penalties with respect thereto) due and owed by the Company and the Subsidiaries or which the Company and the Subsidiaries are obligated to withhold from amounts owing to any employee, creditor or third party, as of the date of this Agreement, have been paid or are accrued on the Latest Balance Sheet and, as of December

31, 1989, all such taxes as of December 31, 1989 will have been paid or will be accrued on Final Balance Sheet; neither the Company nor either Subsidiary has waived any statute of limitations or agreed to the extension of time with respect to a tax assessment or deficiency; the assessment of additional taxes is not expected for prior periods; and, to the best knowledge of the Sellers, there exists no unresolved questions or claims concerning tax liabilities of the Company or either Subsidiary. The federal income tax returns of the Company and the Subsidiaries has been audited by the Internal Revenue Service, or the statutes of limitation with respect to such federal income taxes have expired, for all fiscal years to and including December 31, 1985. Neither the Company nor either of the Subsidiary have ever filed a consent or election under Section 341(f) of the Internal Revenue Code relating to collapsible corporations. Neither the Company nor either Subsidiary is a party to or bound by any agreement relating to the allocation or payment of taxes with the Sellers or any other Person. Neither the Company nor either Subsidiary is required to include in its taxable income for any taxable year ending after the Closing any adjustment under Section 481 of the Internal Revenue Code of 1986 or any similar provision or rule of law.

4M. *Contracts and Commitments*.

(a) Except as set forth on the *Contracts Schedule* attached hereto, neither the Company nor either Subsidiary is a party to any written or oral:

(i) contract with any labor union or any bonus, pension, profit sharing, retirement or any other form of

deferred compensation plan or any stock or partnership interest purchase, stock or partnership interest option plan, hospitalization insurance plan or similar plan or practice, whether formal or informal, or any severance agreements;

(ii) written contract for the employment of any officer, partner, individual employee or other Person on a full-time, part-time or consulting basis;

(iii) agreement or indenture relating to borrowing of money or to mortgaging, pledging or otherwise placing a lien on any of the Company's or either Subsidiary's assets;

(iv) agreements with respect to the lending or investing of funds;

(v) license or royalty agreements;

(vi) guaranty of any obligation for borrowed money or otherwise, other than endorsements made for collection;

(vii) lease or agreement under which it is lessee of or hold or operate any personal property owned by any other party for which the annual rental exceeds $10,000;

(viii) lease or agreement under which it is lessor of or permit any third party to hold or operate any property, real or personal, owned or controlled by it for which the annual rental exceeds $10,000;

(ix) contract or group of related contracts (except oral contracts terminable within 30 days or less without penalty) with the same party for the purchase or

sale of products or services under which the undelivered balance of such products and services has a selling price in excess of $50,000, other than purchase orders or sale orders entered into in the ordinary course of business on the standard forms set forth on *Exhibit 4M* attached hereto;

(x) other contract or group of related contracts (except oral contracts terminable within 30 days or less without penalty) with the same party continuing over a period of more than six months from the date or dates thereof involving more than $50,000, other than purchase orders or sale orders entered into in the ordinary course of business on the standard forms set forth on *Exhibit 4M*;

(xi) contract which prohibits it from freely engaging in business anywhere in the world;

(xii) contract relating to the distribution of its products which obligates any party thereto to make payments in excess of $50,000 during or with respect to any 12 month period, other than purchase orders or sale orders entered into in the ordinary course of business on the standard forms set forth on *Exhibit 4M*;

(xiii) contract with any officer, director, shareholder, or other affiliate (except contracts terminable within 30 days or less without penalty); or

(xiv) other agreement material to the business of the Company or either Subsidiary, whether or not entered into in the ordinary course of business.

(b) Except as specifically disclosed in the *Contracts Schedule* attached hereto, (i) to the best of Sellers' knowledge, no contract or commitment set forth on the *Contracts Schedule*, nor any of those not required to be disclosed thereon, has been breached in any respect or cancelled by any other party since the date of the Latest Balance Sheet, and since the date of the Latest Balance Sheet, none of the Company's or any of the Subsidiaries' ten most significant customers or suppliers has indicated to the Sellers that it will stop or decrease the rate of business done with the Company or such Subsidiary, and (ii) the Company and each of the Subsidiaries have performed all obligations under the contracts listed on the *Contracts Schedule*, nor any of those not required to be disclosed thereon, required to be performed by them and there is no default under any lease, contract, commitment or other agreement to which any of them is a party or any event which, upon given of notice or lapse of time, would constitute such a default.

(c) The *Contracts Schedule* sets forth each contract, commitment or obligation of the Company and each of the Subsidiaries which is secured by a letter of credit or guarantee (other than guarantees by the Company or obligations of the Subsidiaries) and the nature and amount of such security.

(d) Buyer has been supplied with a true and correct copy of all written contracts which are referred to on the *Contracts Schedule* attached hereto, together with all amendments, waivers or other changes thereto. The *Contracts Schedule* contains a description of all material terms of all oral contracts required to be set forth on the *Contracts Schedule*.

4N. *Proprietary Rights*. The *Proprietary Rights Schedule* attached hereto contains a complete and accurate list of all patented and registered Proprietary Rights of the Company and the Subsidiaries and identifies all pending patent applications and applications for registration of other Proprietary Rights owned or filed by or for the Company and the Subsidiaries. The *Proprietary Rights Schedule* also contains a complete and accurate list of all licenses and other rights granted by the Company or any Subsidiary to any third party with respect to Proprietary Rights and licenses and other rights granted by any third party to the Company or either Subsidiary. Except as set forth on the *Proprietary Rights Schedule*:

(a) the Company and the Subsidiaries each own or have the valid right to use all Proprietary Rights necessary for the operation of their respective businesses as now conducted or as currently proposed to be conducted;

(b) the loss or expiration of any Proprietary Right or related group of Proprietary Rights would not have a material adverse effect on the conduct of the Company's or either of the Subsidiary's business and no such loss or expiration is threatened, pending or reasonably foreseeable;

(c) the Company and/or one of the Subsidiaries own and possess all right, title and interest in and to the Proprietary Rights, and no claim by any third party contesting the validity, enforceability, use or ownership of any rights set forth in the Proprietary Rights Schedule has been made, is currently outstanding or is threatened;

(d) no Seller nor any executive of the Company or either Subsidiary has received any notices of, or is aware

of any facts which indicate a likelihood of, any infringement or misappropriation by, or conflict with, any third party with respect to the rights set forth in the Proprietary Rights Schedule; and

(e) neither the Company nor either Subsidiary has infringed, misappropriated or otherwise conflicted with any rights of any third parties, or is aware of any infringement, misappropriation or conflict which will occur as a result of the continued operation of the businesses of the Company and Subsidiaries as now conducted or as currently proposed to be conducted.

4O. *Litigation.* Except as set forth in the *Litigation Schedule* attached hereto, (i) there are no actions, suits, proceedings, orders or investigations pending or, to the best of Sellers' knowledge, threatened against or affecting the Company or either Subsidiary at law or in equity, or before or by any federal, state, municipal or other governmental department, commission, board, bureau, agency or instrumentality, domestic or foreign (including without limitation, with respect to applicable workmen's compensation laws and regulations), and there is no reasonable basis known to the Sellers for any of the foregoing, and (ii) neither the Company, either Subsidiary nor the Sellers have received any opinion or legal advice in writing, within the three years preceding the date hereof, to the effect that the Company or any of the Subsidiaries are exposed from a legal standpoint to any liability or disadvantage which may be material to its business as previously or presently conducted. The Company and each of the Subsidiaries are fully insured with respect to each of the matters set forth on the *Litigation Schedule*.

4P. *Brokerage.* Except as set forth on the *Seller Brokerage Schedule* attached hereto, there are no claims for brokerage commissions, finders' fees or similar compensation in connection with the transactions contemplated by this Agreement based on any arrangement or agreement made by or on behalf of the Sellers, the Company or either Subsidiary.

4Q. *Government Consent, etc.* Except for the filing pursuant to the HSR Act, and expiration or early termination of the statutory waiting period in connection therewith, no permit, consent, approval or authorization of, or declaration to or filing with, any governmental or regulatory authority is required in connection with the execution, delivery or performance of this Agreement by the Sellers or the consummation by the Sellers of any other transaction contemplated hereby.

4R. *Employees.* To the best of Sellers' knowledge, except for Arthur L. Gustafson, Daniel R. McLean, Francis L. Butler, William Lord and Henry Young, no key employee and no group of employees of the Company or either Subsidiary has any plans to terminate or modify his or her employment with the Company or such Subsidiary. Except as set forth on the *Compliance Schedule* attached hereto, the Company and each of the Subsidiaries have complied with all applicable laws relating to the employment of labor, including, without limitation, provisions thereof relating to wages, hours, equal opportunity, collective bargaining and the payment of social security and other taxes, and within the last five years neither the Company nor either Subsidiary has experienced any strikes, grievances, unfair labor practices

claims or other labor relations problems, including, without limitation, any disputes with former employees regarding termination and/or severance pay. Except as set forth in the *Employee Contracts Schedule* attached hereto, and except as otherwise expressly contemplated by this Agreement, neither the Company nor either Subsidiary has entered into any oral or written employment agreements not terminable by the Company or such Subsidiary on less than 30 days notice and without any penalty or additional payments. To the best of the Sellers' knowledge, (i) there are no claims, actions, proceedings or investigations pending or threatened against any of the employees of the Company or either Subsidiary and (ii) no employee of the Company or either Subsidiary is subject to any non-compete or nondisclosure agreement.

4S. *Related Party Transactions.* Except as described on the *Related Party Schedule* attached hereto, neither the Company nor either Subsidiary is a party to any agreement or transaction with any Related Party. "Related Party" means any Person or entity controlled by, controlling or under common control with the Company or either Subsidiary and shall include the Sellers and their affiliates.

4T. *Employee Benefit Plans.*

(a) With respect to current or former employees of the Company or either Subsidiary, neither the Company nor either Subsidiary maintains or contributes to any (i) nonqualified deferred compensation or retirement plans or arrangements, (ii) qualified defined benefit plans (including multiemployer pension plans) or arrangements which are employee pension benefit plans (as

defined in Section 3(2) of the Employee Retirement Income Security Act of 1974 ("ERISA")) or (iii) employee welfare benefit plans (as defined in Section 3(a) of ERISA) which provide health, accident or life insurance benefits to former employees, their spouses or dependents, other than in accordance with Section 4980(B) of the Internal Revenue Code of 1986 (the "Code"). Neither the Company nor either Subsidiary maintains or contributes to, or has within the last five years maintained or contributed to, any defined benefit pension plan or contributed to any multiemployer pension plan (as defined in Section 3(37) of ERISA). Except as set forth on the *Employee Benefits Schedule*, neither the Company nor either Subsidiary maintains or contributes to any qualified defined contribution plans or arrangements which are employee pension benefit plans, any employee welfare benefit plans, or any material fringe benefit plans or programs.

(b) The Alloyd Co., Inc. Profit Sharing Plan & Trust (the "Profit Sharing Plan") and all employee welfare benefit plans (and related trusts and insurance contracts) comply in form and in operation in all respects with the applicable requirements of ERISA and the Code. The Profit Sharing Plan meets the requirements of a "qualified plan" under Section 401(a) of the Code and, except as set forth on the *Compliance Schedule*, has received a favorable determination letter from the Internal Revenue Service.

(c) Except as set forth on the *Compliance Schedule*, all required reports and descriptions (including Form 5500 Annual Reports, Summary Annual Reports and Summary Plan Descriptions) with respect to the Profit Sharing Plan and all employee welfare benefit plans have been properly filed with the appropriate government agency or

distributed to participants, and the Company has complied with the requirements of Section 4980(B) of the Code.

(d) Neither the Company nor either subsidiary has incurred any liability to the Pension Benefit Guaranty Corporation ("PBGC"), the Internal Revenue Service or any multiemployer plan with respect to any employee pension benefit plan. Except as otherwise expressly contemplated hereby, no separation, severance termination or similar type benefit will become payable to any employee of the Company or either Subsidiary solely as a result of any transaction contemplated by this agreement.

(e) With respect to the Profit Sharing Plan, all contributions for prior plan years have been made, and with respect to the current plan year all contributions declared by the Company's or any Subsidiary's board of directors have been made. Neither the Company nor any Subsidiary has any outstanding obligation to make any contributions to the Profit Sharing Plan with respect to any plan year or portion thereof prior to the Closing Date.

(f) With respect to the Profit Sharing Plan and each employee welfare benefit plan, (i) there have been no prohibited transactions as defined in Section 406 of ERISA or Section 4975 of the Code, (ii) no fiduciary (as defined in Section 3(21) of ERISA) has any liability for breach of fiduciary duty or any other failure to act or comply in connection with the administration or investment of the assets of such plans, and (iii) no actions, investigations, suits or claims with respect to the assets thereof (other than routine claims for benefits) are pending or threatened, and the Sellers have no knowledge of

any facts which would give rise to or could reasonable [sic] be expected to give rise to any such actions, suits or claims.

(g) With respect to the Profit Sharing Plan and to each employee welfare benefit plan, Sellers have furnished or made available to Buyer true and complete copies of (i) the plan documents and summary plan descriptions, (ii) except as set forth on the *Compliance Schedule*, the most recent determination letter received from the Internal Revenue Service, (iii) the last Form 5500 Annual Report, and (iv) all related trust agreements, insurance contracts or other funding agreements which implement such plans.

4U. *Officers and Directors: Bank Accounts.* The *Officers and Directors Schedule* attached hereto lists all officers and directors of the Company and the Subsidiaries, The attached *Bank Accounts Schedule* lists all of the bank accounts, safe deposit boxes and lock boxes of the Company and the Subsidiaries (designating each authorized signer). Neither the Company nor either Subsidiary has granted a power of attorney to any Person or entity which has not been terminated. To the best knowledge of Sellers, there are no claims actions, proceedings or investigations pending or threatened against any of the officers, directors or partners of the Company or either Subsidiary with respect to the Company's or either Subsidiary's business.

4V. *Insurance.* True and correct copies of each insurance policy maintained by the Company and each of the Subsidiaries with respect to their properties, assets and businesses have, been made available to Buyer. All of the

Company's and the Subsidiaries' insurance policies are in full force and effect, and neither the Company nor either Subsidiary is in default with respect to its obligations under any of such insurance policies. If between the date hereof and the Closing Date, the Company or either Subsidiary desire to alter any insurance policy, the Company or such Subsidiary, as the case maybe [sic], must obtain Buyer's prior written consent to any such change, which consent will not be unreasonably withheld.

4W. *Compliance with Laws: Permits: Certain Operations.*

(a) Except as set forth on the *Compliance Schedule* attached hereto, except for the environmental matters addressed in Section 4W(b) below, and except for matters which will not result in material Losses to the Company and the Subsidiaries (which Losses shall be deemed "material" for purposes of this Section 4W(a) only in the event and then only to the extent such Losses in the aggregate exceed $30,000);

(i) The Company, the Subsidiaries, and their respective officers, directors, partners, agents and employees have complied with all applicable laws, ordinances, rules, requirements and regulations of foreign, federal, state and local governments and all agencies thereof which affect the businesses, operation or any owned or leased properties of the Company and the Subsidiaries and to which the Company and the Subsidiaries may be subject, and no notices have been received by, and no claims have been filed against the Company or either Subsidiary alleging a violation of any such laws, ordinances, rules, requirements or regulations;

(ii) Each of the Company and the Subsidiaries holds all of the permits, licenses, certificates or other authorizations of foreign, federal, state and local governmental agencies required for the conduct of its business. In particular, but without limiting the generality of the foregoing, each of the Company and the Subsidiaries has obtained all material permits, licenses and other authorizations which are required under federal, state and local laws relating to public health and safety and worker health and safety;

(iii) The Company and the Subsidiaries are in compliance with all terms and conditions of any and all required permits, licenses and authorizations, and are also in compliance with all other limitations, restrictions, conditions, standards, prohibitions, requirements, obligations, schedules and timetables contained in any foreign, federal, state or local law or any regulation, code, plan, order, decree or judgment relating to public health and safety and worker health and safety, or any notice or demand letter issued, entered, promulgated or approved thereunder; and

(iv) No facts, events or conditions interfere with or prevent continued compliance with, or give rise to any present or potential legal, common law or statutory liability under, any law or regulation relating to public health and safety and worker health and safety to which the Company or either Subsidiary is a party, subject or bound.

(b) Without limiting the generality of Section 4W(a) above, except as set forth on the *Compliance Schedule*: (i) the Company and each of the Subsidiaries have obtained

all permits, licenses and other authorizations which are required under foreign, federal, state and local laws relating to pollution or protection of the environment, including laws relating to emissions, discharges, releases or threatened releases of pollutants, contaminants or hazardous or toxic materials or wastes into ambient air, surface water, ground water, or lands or otherwise relating to the manufacture, processing, distribution, use, treatment, storage, disposal, transport or handling of pollutants, contaminants or hazardous or toxic materials or wastes; (ii) the Company and each of the Subsidiaries are in compliance with all terms and conditions of any and all required permits, licenses and authorization, and are also in compliance with all other limitations, restrictions, conditions, standards, prohibitions, requirements, obligations, schedules and timetables contained in any federal, state or local law or any regulations, code, plan, order, decree or judgment relating to pollution or protection of the environment or any notice or demand letter issued, entered, promulgated or approved thereunder; (iii) no facts, events or conditions interfere with or prevent continued compliance with, or give rise to any legal, common law or statutory liability under, any current or prior applicable law or regulation related to the disposal, storage, transport or handling, or related to the emission, discharge, release or threatened release into the environment, of any pollutant, contaminant, or hazardous or toxic material or waste, and (iv) neither the Company nor either Subsidiary has knowingly or unknowingly nor, to the best knowledge of the Sellers, has any predecessor of the Company or either Subsidiary or any previous owner of the parcels of real property described on the *Owned*

Property Schedule, stored, handled, disposed of or released or emitted into the environment any chemical or toxic material or waste or hazardous material or petroleum or crude oil or fraction thereof in any manner which may form the basis for any claim, demand or action under any current or prior applicable law or regulation seeking cleanup of any site, location or body of water, surface or subsurface. There are no abandoned, closed or not-in-service underground storage tanks located on the real property described on the *Owned Property Schedule.*

4X. *Product Warranty.* Each product manufactured, sold, leased or delivered by the Company or either Subsidiary has been in conformity with all applicable contractual commitments and all express and implied warranties. Except for matters which will not result in material Losses to the Company and the Subsidiaries (which Losses shall be deemed "material" for purposes of this Section 4X only in the event and then only to the extent such Losses in the aggregate exceed $30,000), no liability exists for replacement or repair of such products or other damages in connection therewith and no products manufactured, sold, leased or delivered by the Company or either Subsidiary are subject to any guaranty, warranty or other indemnity beyond the applicable standard terms and conditions of sale or lease.

4Y. *Product Liability.* Except as set forth on the *Litigation Schedule*, there is not existing liability, claim or obligations arising from or alleged to arise from any actual or alleged injury to persons or property as a result of the ownership, possession or use of any of the products manufactured, sold, leased or delivered by the Company or either Subsidiary.

4Z. *Disclosure.* Neither this Agreement, nor any of the Schedules, attachments or exhibits hereto, contain any untrue statement of a material fact or omit a material fact necessary to make the statements contained herein or therein, in light of the circumstances in which they were made, not misleading. There is no material fact which has not been disclosed to Buyer of which the Sellers or the officers or directors of the Company or either Subsidiary are aware and which materially adversely affects the Company's or either Subsidiary's business, financial condition, operating results, assets, operations or business prospects.

4AA. *Closing Date.* All of the representations and warranties of Sellers in this Article IV and elsewhere in this Agreement all information delivered in any schedule, attachment or exhibit hereto or in any certificate delivered to Buyer are true and correct on the date of this Agreement and will be true and correct at the Closing Date as though then made and as though the Closing Date were substituted for the date of this Agreement throughout such representations and warranties, except for representations and warranties expressly made as of a date other than the date hereof, in which case such representations and warranties will be true and correct as of such date only.

ARTICLE V

REPRESENTATIONS AND WARRANTIES OF BUYER

5A. *Corporate Organization and Power.* Buyer is a corporation duly organized and validly existing under the laws of the State of Delaware, with full corporate power

and authority to enter into this Agreement and perform its obligations hereunder.

5B. *Authorization: No Breach.* The execution, delivery and performance of this Agreement by Buyer and the consummation of the transactions contemplated hereby have been duly and validly authorized by all requisite corporate action on the part of Buyer, and no other corporate proceedings on the part of Buyer are necessary to authorize the execution, delivery, or performance of this Agreement. This Agreement, the Notes and the Escrow Agreement to be delivered in connection herewith constitute valid and binding obligations of Buyer, enforceable in accordance with their respective terms, except as may be limited by applicable debtor relief laws and general principles of equity.

5C. *No Violation.* Buyer is not subject to or obligated under its certificate of incorporation, its by-laws, any applicable law, or rule or regulation of any governmental authority, or any agreement or instrument, or any license, franchise or permit, or subject to any order, writ, injunction or decree, which would be breached or violated by its execution, delivery or performance of this Agreement, except to the extent valid consents and approvals or waivers have been obtained. Buyer will comply with all applicable laws and with all applicable rules and regulations of all governmental authorities in connection with its execution, delivery and performance of this Agreement and the consummation of the transactions contemplated hereby.

5D. *Governmental Authorities and Consents.* Except for the filing pursuant to the HSR Act, and expiration or

early termination of the statutory waiting period in connection therewith, Buyer is not required to submit any notice, report or other filing with any governmental authority in connection with the execution or delivery by it of this Agreement or the consummation of the transactions contemplated hereby. Except for the filing pursuant to the HSR Act, and expiration or early termination of the statutory waiting period in connection therewith, no consent, approval or authorization of any governmental or regulatory authority or any other party or Person is required to be obtained by Buyer in connection with its execution, delivery and performance of this Agreement or the transactions contemplated hereby.

5E. *Brokerage.* Except as set forth on the *Buyer Brokerage Schedule* attached hereto, there are no claims for brokerage commissions, finders' fees or similar compensation in connection with the transactions contemplated by this Agreement based on any arrangement or agreement made by or on behalf of Buyer.

5F. *Litigation.* There are no actions, suits, proceedings, orders or investigations pending or, to the best of Buyer's knowledge, threatened against or affecting Buyer at law or in equity, or before or by any federal, state, municipal or other governmental department, commission, board, bureau, agency or instrumentality, domestic or foreign, which would adversely affect Buyer's performance under this Agreement or the consummation of the transactions contemplated hereby.

5G. *Notification.* From the date hereof to the Closing, Buyer will promptly inform the Sellers' Spokesperson in writing of any material variance from the

representations and warranties contained in this Article V.

5H. *Investment Purpose.* Buyer is purchasing the Purchased Shares hereunder for its own account and not with a view to, or present intention of, distribution thereof in violation of the Securities Act of 1933, as amended (the "1933 Act"). The Buyer believes that it has had a reasonable opportunity to ask questions of and receive information and answers from the Sellers or Persons acting on behalf of the Sellers concerning this Agreement and the transactions contemplated herein.

5I. *Disclosure.* There is no material fact of which Buyer has actual knowledge which materially adversely affects the Company's or the Subsidiaries' businesses or operations or which would otherwise if disclosed to Sellers cause a breach under the Sellers' representations, warranties, covenants and agreements contained herein. For the purposes of this Agreement, the "actual knowledge" of Buyer shall mean the actual knowledge of the general partners of Wind Point Partners II. L.P.

ARTICLE VI

TERMINATION

6A. *Termination.* This Agreement may be terminated at any time prior to the Closing,

(a) by mutual consent of Buyer and the Sellers' Spokesperson, on behalf of the Sellers;

(b) by either Buyer or the Sellers' Spokesperson, on behalf of the Sellers, if there has been a material misrepresentation, material breach of warranty or material

breach of a covenant on the part of the other party in the representations and warranties or covenants set forth in this Agreement which has not been cured prior to such termination; or

(c) by either Buyer or the Sellers' Spokesperson, on behalf of the Sellers, if the transactions contemplated hereby have not been consummated by January 15, 1990; *provided* that neither Buyer nor the Sellers' Spokesperson, on behalf of the Sellers, will be entitled to terminate this Agreement pursuant to this Section 6A(c) if such party's breach of this Agreement has prevented the consummation of the transactions contemplated hereby.

6B. *Effect of Termination.* In the event of termination of this Agreement by either Buyer or the Sellers' Spokesperson, on behalf of the Sellers, as provided above, this Agreement will forthwith become void and there will be no liability on the part of either Buyer or Sellers, except for breaches of this Agreement prior to the time of such termination, and except that the covenants and agreements set forth in Sections 1E, 7D and 7G shall survive such termination indefinitely.

ARTICLE VII

ADDITIONAL AGREEMENTS

7A. *Survival of Representations and Warranties.* The representations and warranties set forth in this Agreement or in any writing delivered by Buyer or the Sellers to the other party in connection with this Agreement will survive the Closing Date for a period which commences on the Closing Date and continues up to and including

April 30, 1991, and shall not be affected by any examination made for or on behalf of Buyer or the Sellers, or the knowledge of any of Buyer's or the Company's officers, directors, shareholder, employees or agents, except as otherwise provided herein or as has been specifically disclosed in the Schedules attached hereto; *provided*, that (i) the representations and warranties made by the Sellers in Sections 4B, 4L and 4P hereof shall survive the Closing Date and continue in full force and effect indefinitely, (ii) the representations and warranties made by the Sellers in Section 4W(b) shall survive the Closing Date and continue in full force and effect for a period of three years following the Closing Date.

7B. *Indemnification.*

(a) Subject to the limitations set forth in Section 7B(b) below, the Sellers jointly and severally (but severally only with respect to the matters set forth in Section 7B(d)) agree to indemnify Buyer and hold it harmless against any loss, liability, penalty, deficiency, damage or expense (including reasonable legal expenses and costs) (individually, a "Loss" and collectively, the "Losses") which Buyer or its subsidiaries (including, after the Closing, the Company and the Subsidiaries) may suffer, sustain or become subject to, as a result of (i) the breach by the Sellers of any representation or warranty made by the Sellers contained in Article IV of this Agreement (other than the representations and warranties contained in Section 4B, and 4P); (ii) the breach by the Sellers of any representation and warranty contained in Section 4B and 4P; (iii) the breach by the Sellers of any representation,

warranty (other than representations or warranties contained in Article IV hereof), covenant or agreement contained in this Agreement or any agreements contemplated hereby or any Exhibit hereto, including, without limitation, subject to Section 7B(d) below, the Non-Compete Agreement and the provisions contained in Section 5 of the Executive Employment Agreements; (iv) any franchise tax or corporate income tax liabilities arising from the failure of the Company or any Subsidiary to qualify to do business as a foreign corporation in and file income tax returns with the States of Florida, Michigan and Tennessee, (v) the removal prior to the Closing Date of underground storage tanks and any associates soil and ground water contamination located on the DeKalb Property, including, without limitation, the assessment and remediation on or after the Closing Date of any contamination associated with the Stoddard solvent tanks; (vi) the litigation matters set forth on the *Litigation Schedule*, to the extent Buyer is not fully reimbursed for any Losses resulting from or related to such litigation matters by the Company's current insurance carriers pursuant to the Company's insurance policies in effect as of the Closing Date; and (vii) any loss, impediment or interference with, of or to any utility service necessary to the use, occupancy and ownership of the real property set forth on the *Owned Property Schedule* (the "Owned Real Property"), including, without limitation, sewer, gas, water, electricity and telephone service, in any way related to the absence of legal, irrevocable appurtenant easements serving or encumbering the Owned Real Property.

(b) Sellers' obligations to indemnify Buyer pursuant to Section 7B(a) above shall be subject to the following limitations:

(i) Sellers will be liable to indemnify Buyer with respect to claims referred to in Sections 7B(a)(i), 7B(a)(iv), 7B(a)(vi) and 7B(a)(vii) above only to the extent that the aggregate amount of Losses for which Buyer would otherwise be entitled to indemnification with respect to such claims under this Section 7B exceeds $500,000.

(ii) Sellers will be liable to indemnify Buyer with respect to the claims referred to in Section 7B(a)(i) and 7B(a)(vii) only if, (x) with respect to claims for breaches of the representations and warranties set forth in Section 4A, 4C through 4K, 4M through 4O, 4Q through 4W(a) and 4X through 4AA, Buyer gives written notice thereof to the Sellers on or prior to April 30, 1991, (y) with respect to claims arising from the matters set forth in Section 7B(a)(vii) above, Buyer gives written notice thereof to the Sellers within five years after the Closing Date, and (z) with respect to claims for breaches of the representations and warranties set forth in Section 4W(b), Buyer give [sic] written notice thereof to the Sellers within three years after the Closing Date.

(iii) Sellers shall not be liable to indemnify Buyer with respect to claims referred to in Sections 7B(a)(i), 7B(a)(iii) through 7B(a)(vii) above to the extent that the aggregate Purchase Price delivered by Buyer to the Sellers pursuant to Section 1B(b) and 1C(a); provided, that the foregoing limitation shall not apply with respect

to any Losses arising from a breach of the representations and warranties set forth in Section 4B.

(c) Buyer's rights to indemnification set forth in this Section 7B are in addition to any other remedies that Buyer may otherwise have against the Sellers at law or in equity for Sellers' breach of the representations, warranties, covenants and agreements made by the Sellers in this Agreement or any Exhibit hereto. In addition to any other such remedy Buyer may have against the Sellers, including, without limitation, Buyer's express right to proceed against any Seller on a joint and several (several, with respect to the matters set forth in Section 7B(d)) basis for any claim for indemnification Buyer may have against such Seller pursuant to Section 7B(a) hereof, Buyer may satisfy any claim for indemnification it may have against the Sellers by exercising either or both of the following remedies:

(i) Pursuant to the provisions of the Notes, Buyer may offset any amounts due or to become due under the Notes against any claim for indemnification made by Buyer against the Sellers pursuant to this Section 7B or otherwise at law or in equity. Any such offset shall effect the timing and amount of payments required under the Notes in the same manner as if Buyer had made a permitted prepayment pro rata thereunder; and

(ii) In accordance with the terms of the Escrow Agreement, Buyer may make a claim against the Escrow Fund for any claim for indemnification made by Buyer against the Sellers pursuant to this Section 7B or otherwise at law or in equity.

Notwithstanding the foregoing provisions of this Section 7B(c), to the extent that the Escrow Fund is sufficient to satisfy a Loss, Buyer shall, prior to the exercising any right of offset against the Notes and prior to exercising any of Buyer's other remedies against the Seller's, including, without limitation, Buyer's express right to proceeds against any Seller on a joint and several (several, with respect to the matters set forth in Section 7B(d)) basis for any claim for indemnification Buyer may have against such Seller pursuant to Section 7B(a) hereof, first make a claim for such Loss against the Escrow Fund in accordance with the terms of the Escrow Agreement; *provided*, however, that nothing herein shall prohibit Buyer from making an offset against the Notes or exercising any of Buyer's other remedies against the Sellers simultaneously with a claim against the Escrow Fund to the extent that the Escrow Fund is insufficient to satisfy any Loss. Notwithstanding anything to the contrary in this Section 7B, including any contrary implications created by this Section 7B(c), Buyer hereby expressly waives any and all rights it may have to seek the remedy of recision against the Sellers in connection with the Sellers' breach of any provision of this Agreement or any Exhibit hereto.

(d) Notwithstanding anything in this Section 7B to the contrary, each Seller's obligation to indemnify Buyer for such Seller's breach of the representations and warranties set forth in Section 4B(ii), Gustafson's obligation to indemnify Buyer for any breach by Gustafson of the Non-Compete Agreement, McLean's obligation to indemnify Buyer for any breach by McLean of the provisions contained in Section 5 of the Executive Employment Agreement to which he is a party, and Butler's obligation

to indemnify Buyer for any breach by Butler of the provisions contained in Section 5 of the Executive Employment Agreement to which he is a party, are each several and not joint in nature.

(e) Subject to Section 7B(f) below, Buyer agrees to indemnify the Sellers and hold them harmless against any Losses which Sellers may suffer, sustain or become subject o [sic], as the result of a breach of any representation, warranty, covenant or agreement by Buyer contained in this Agreement or any Exhibit hereto.

(f) The indemnification provided in Section 7B(e) above is subject to the following limitations with respect to claims for breaches of any representation or warranty contained in Article V:

(i) Buyer will be liable to the Sellers for any Losses only if the aggregate amount of Losses exceeds $250,000.

(ii) Buyer will not be liable to the Sellers for any Losses arising from any su^h breach unless written notice specifying the nature of such claim is given by the Sellers' Spokesperson to Buyer on or prior to April 30, 1991.

(g) The party seeking indemnification (the "Indemnified Party") agrees to give the party from whom indemnification is sought (the "Indemnifying Party") timely notice with reasonably available detailed particulars of any claim with respect to which the Indemnifying Party has agreed to indemnify the Indemnified Party under this Section 7B; *provided*, that any delay in the giving of such notice will not relieve the Indemnifying Party from liability under this Section 7B unless and only to the extent

such delay materially damages the Indemnifying Party access to such information possessed by the Indemnified Party as the Indemnifying Party reasonably requests relating to such claim. The Indemnified Party shall initially undertake the defense of any third party claim until the Indemnifying Party has acknowledged in writing that the Indemnifying Party is indemnifying the Indemnified party with respect to any third Party claim, whether or not involving litigation, at which point the Indemnifying Party will be entitled to assume the defense of any such claim; *provided* that the Indemnified Party may at its election participate (as its own expense) in such defense to the extent that in its sole discretion it believes that such claim will affect its ongoing business. At the Indemnifying Party's reasonable request, the Indemnified party will cooperate with the Indemnifying Party in the preparation of any such defense if the Indemnifying Party reimburse the Indemnified Party for any reasonable expenses incurred in connection with such request. The Indemnifying Party will not settle any such claim for consideration other than money without the prior written consent of the Indemnified Party, which shall not be unreasonably withheld.

(h) Notwithstanding any provision of this Agreement to the contrary, any disclosures made by Sellers on the Schedules attached to this Agreement which relate tot he [sic] matters described in Sections 7B(a)(iv) through 7B(a)(vii) hereof shall not in any respect limit Seller's obligation to indemnify Buyer for any Losses as a result of those matters so set forth in Sections 7B(a)(iv) through 7B(a)(vii) hereof.

7C. *Press Release and Announcements.* No press releases or public announcement related to the Agreement and the transactions contemplated herein, or other announcements to the employees, customers and suppliers of the Company or the Subsidiaries will be issued without the prior joint approval of Buyer and the Sellers' Spokesperson.

7D. *Expenses.* Each party hereto will pay all of its own expenses (including, without limitation, the fees and expenses of legal counsel, accountants, investment brokers, brokers or other representatives and consultants and appraisal fees and expenses and other out-of-pocket expenses) in connection with the negotiation and execution of this Agreement, the performance of its obligations hereunder and the consummation of the transactions contemplated by this Agreement (whether consummated or not); *provided,* that the Sellers will pay (i) all sales taxes, transfer taxes, transfer fees, stamp taxes, recording fees and the like arising from the consummation of the transactions contemplated hereby, and (ii) all of the expenses up to $20,000 incurred in connection with their satisfaction of the closing conditions set forth in Sections 2A(o)(ix) and 2A(o)(x) hereof. The Sellers represent and warrant to Buyer that the Company has not, and hereby covenant to the Buyer that the Company will not, be charged for any expenses (including legal fees and costs) incurred by the Sellers or by the Company on behalf of the Sellers, in connection with the negotiation and execution of this Agreement and the consummation of the transactions contemplated by this Agreement (collectively, the "Transaction Expenses") except for such

expenses which are fully reimbursed to the Company by the Sellers on or prior to the Closing Date.

7E. *Further Transfers.* The Sellers will execute and deliver such further instruments of conveyance and transfer and take such additional action as Buyer may reasonably request to effect, consummate, confirm or evidence the transfer to Buyer of the Purchased Shares, and Sellers will execute such documents as may be necessary to assist Buyer in preserving or perfecting its rights in the Purchased Shares. Without limiting the generality of the foregoing, Sellers and Buyer agree to cooperate with each other and to provide each other with all information and documentation reasonably necessary to permit the preparation and filing of all federal, state, local, and other tax returns with respect to the Company; provided that each party shall reimburse the other party for such other party's reasonable out-of-pocket expenses in connection with such other party's compliance with this Section 7E.

7F. *Transition Assistance.* From the date hereof, Sellers will not in any manner take or cause to be taken any action which is designed or intended, or might be reasonably anticipated to have the effect of discouraging customers, suppliers, lessors, and other business associates from maintaining the same business relationships with Buyer, the Company or the Subsidiaries after the date of this Agreement as were maintained with the Company and the Subsidiaries prior to the date of this Agreement.

7G. *Confidentiality.* If the transactions contemplated by this Agreement are not consummated, then in addition to complying with Buyer's obligations under the Letter

Agreement between Wind Point Partners, L.P. and the Company dated October 17, 1989, as amended by the Letter of Amendment dated as of November 1, 1989, Buyer will keep confidential all information and materials regarding the Company and the Subsidiaries reasonably designated by the Sellers as confidential (except to the extent (i) required by law, (ii) the information was previously known to Buyer through a third party not subject to and not otherwise in breach of a confidentiality obligation owed to Sellers, the Company, or a Subsidiary or (iii) the information becomes publicly known except through the actions or inactions of Buyer). Whether or not the transactions contemplated hereby are consummated, the Sellers will return to Buyer and keep confidential all information and materials regarding Buyer reasonably designated by Buyer as confidential (except to the extent (i) required by law, (ii) the information was previously known to the Sellers through a third party not subject to and not otherwise in breach of a confidentiality obligation owed through or (iii) the information becomes publicly known except through the actions or inactions of the Sellers). If the transactions contemplated hereby are consummated, the Sellers will maintain as confidential and will not use or disclose (except as required by law or as authorized in writing by Buyer) any confidential or proprietary information or materials regarding the Company and the Subsidiaries. The Sellers represent and warrant that they have delivered to Buyer all trade secrets, formula and other proprietary information regarding the Company and the Subsidiaries which they possess. The parties hereto agree that money damages would be inadequate for any breach of this Section 7G. Hence, in the

event of either party's breach of this Section 7G, the other party (or its successor or assigns) may, in addition to the other rights and remedies existing in its favor, apply to any court of competent jurisdiction for specific performance and/or injunctive or other relief, in order to enforce, or prevent any violation of, the provisions hereof.

7H. *Investment Representations Regarding the Notes.* In connection with the receipt of the Notes hereunder from Buyer, each of the Sellers hereby represents and warrants to Buyer that:

(a) Such Seller has reviewed this Agreement and the Note;

(b) Such Seller has had an opportunity to ask questions and receive answers concerning the terms and conditions of the offering of the Notes, has had full access to such other information concerning Buyer as such Seller has requested and possesses substantial information about, and familiarity with, the businesses of the Company and the Subsidiaries;

(c) Such Seller has such knowledge and experience in business and financial matters that he is capable of evaluating the merits and risks of the investment in the Notes to be made pursuant to this Agreement, and is able to bear the economic risk of the investment in the Notes for an indefinite period of time;

(d) Such Seller is acquiring the Notes hereunder for his own account with the present intention of holding

such securities for investment purposes and has no intention of selling such securities in a public distribution in violation of federal or state securities laws; and

(e) Such Seller is an "Accredited Investor" as such term is defined in Regulation D promulgated under the Securities Act of 1933.

7I. *Restriction on Transfer of the Notes.* Sellers will not transfer the Notes without the delivery of prior written notice to Buyer describing in reasonable detail the transfer or proposed transfer, together with an opinion (reasonably satisfactory to Buyer) of counsel (reasonably satisfactory to Buyer) to the effect that such transfer may be effected without registration of such Notes under state or federal securities law.

7J. *Regulatory Filings.* The Sellers, the Company and the Buyer shall make or cause to be made all filings and submissions under the HSR Act and any other laws or regulations applicable to any of the Buyer, the Company or any Seller necessary for the consummation of the transactions contemplated herein. The Sellers, the Buyer and the Company will coordinate the cooperate with each other in exchanging such information and will provide such reasonable assistance as each party may request of the other in connection with all of the foregoing.

7K. *Certain Limitations on Buyer's Actions with Respect to Environmental Matters.* Except upon the request or demand of (i) any governmental agency, (ii) any potential buyer of the Company or any substantial portion of the Company's assets or capital stock; or (iii) any investor in or lender to the Company or any Subsidiary, or upon reasonable suspicion of Buyer, in its sole discretion, of the

presence or existence of hazardous, toxic or other materials or substances in or on the soil or groundwater of, at, or below the property owned, leased or operated by the Company or any Subsidiary or the omission, release or discharge or threatened release of such substances or materials, in, on, into or from such property, Buyer will not undertake any sampling or investigations of environmental conditions at such property from the Closing Date until the expiration of the time periods set forth in Sections 7A and 7B for the survival of the representations and warranties made by the Sellers in Section 4V(b).

ARTICLE VIII

MISCELLANEOUS

8A. *Amendment and Waiver.* This Agreement may be amended, or any provision of this Agreement may be waived; *provided* that any such amendment or waiver will be binding on the Sellers only if such amendment or waiver is set forth in a writing executed by Sellers' Spokesperson or in a joint writing executed by each of the Sellers, and that any such amendment or waiver will be binding upon Buyer only if such amendment or waiver is set forth in a writing executed by Buyer. No course of dealing between or among the parties will be deemed effective to modify, amend or discharge any part of this Agreement or any rights or obligations of either party under or by reason of this Agreement.

8B. *Notices.* All notices, demands and other communications to be given or delivered under or by reason of the provisions of this Agreement will be in writing and will be deemed to have been given when (i) personally

delivered, sent by telecopy, overnight express courier or (ii) mailed by certified or registered mail, postage prepaid. Notices, demands and communications to the Sellers and Buyer will, unless another address is specified in writing, be sent to the address indicated below:

Notices to the Sellers:

Sellers' Spokesperson

Arthur L. Gustafson
40W111 Burlington Road
St. Charles, IL 60174; and

Daniel R. McLean
311 Thornbrook
DeKalb, IL 60115

Individually

Arthur L. Gustafson
40W111 Burlington Road
St. Charles, IL 60174

Daniel R. McLean
311 Thornbrook
DeKalb, IL 60115

Francis I. Butler
259 Arlington
Elmhurst, IL 60126

with a copy to:

Vedder, Price, Kaufman & Kammholz
222 North LaSalle Street
Chicago, Illinois 60601
Attn: Thomas P. Desmond, Esq.

with a copy to:

Fitzgerald & Gottlick
55 West Monroe Street, Suite 3401
Chicago, Illinois 60603
Attn: John D. Gottlick, Esq.

Notices to Buyer:

Alloyd Holdings, Inc.
c/o Wind Point Partners, L.P.
1525 Howe Street
Racine, Wisconsin 53403
Attn: Richard R. Kracum

with a copy to:

Kirkland & Ellis
200 East Randolph Drive
Chicago, Illinois 60601
Attention: Karl E. Lutz, Esq. and
Steven V. Napolitano, Esq.

8C. *Assignment.* This Agreement and all of the provisions hereof shall be binding upon and inure to the benefit of the parties hereto and their respective heirs, successors and assigns; *provided* that (i) no such assignment shall relieve the assigning party of its obligations to make any payment pursuant to this Agreement and (ii) no such assignment shall relieve the assigning party of its obligation to indemnify the other party pursuant to Section 7B. The term "assignment" as used herein includes, without limitation, assignments by merger or otherwise by operation of law.

8D. *Severability.* Whenever possible, each provision of this Agreement will be interpreted in such manner as to be effective and valid under applicable law, but if any provision of this Agreement is held to be prohibited by or

invalid under applicable law, such provision will be ineffective only to the extent of such prohibition or invalidity, without invalidating the remainder of such provisions or the remaining provisions of this Agreement.

8E. *Captions.* The captions used in this Agreement are for convenience of reference only and do not constitute a part of this Agreement and will not be deemed to limit, characterize or in any way affect any provision of this Agreement, and all provisions of this Agreement will be enforced and construed as if no caption had been used in this Agreement.

8F. *Complete Agreement.* This Agreement and the agreements and documents referred to herein contain the complete agreement between the parties and supersede any prior understandings, agreements or representations by or between the parties, written or oral, which may have related to the subject matter hereof in any way. Without limiting the foregoing, this Agreement supersedes the Letter Agreement dated October 17, 1989, as amended by the Letter of Amendment dated as of November 1, 1989 and such Letter Agreement, as so amended, shall have no further force and effect.

8G. *Counterparts.* This Agreement may be executed in one or more counterparts all of which taken together will constitute one and the same instrument.

8H. *Governing Law.* The internal law (and not the law of conflicts) of the State of Illinois will govern all questions concerning the construction, validity and interpretation of this Agreement and the performance of the obligations imposed by this Agreement.

8I. *Disclosure Generally.* If and to the extent that any information required to be furnished or disclosed in any Schedule is contained in this Agreement or in any other Schedule attached hereto, such information shall be deemed to be included in each Schedule in which the information is required to be included to the extent the applicability thereof to each such Schedule is clearly apparent.

8J. *No Strict Construction.* The language used in this Agreement will be deemed to be the language chosen by the parties hereto to express their mutual intent and no rule of strict construction will be applied against any Person.

* * *

IN WITNESS WHEREOF, the parties hereto have executed this Agreement as of the date first written above.

ALLOYD HOLDINGS, INC.

By /s/ R R Kracum

Its Chairman

Number of Purchased Shares to be Purchased Hereunder	
83.00	/s/ Arthur L. Gustafson Arthur L. Gustafson
3.929	/s/ Daniel R. McLean Daniel R. McLean
1.964	/s/ Francis I. Butler * Francis I. Butler

Exhibits

Exhibit 1B(a)	Certification of Estimated Adjustment Amount
Exhibit 1B(b).1	Form of Promissory Note
Exhibit 1B(b).2	Escrow Agreement
Exhibit 2A(k)	Non-Compete Agreement
Exhibit 2A(l)	Form of Executive Stock and Employment Agreement
Exhibit 2A(n)	Opinion of Sellers' Counsel
Exhibit 2A(o)	Sellers' Certificate
Exhibit 2A(p)	Form of Subordination Agreement
Exhibit 2B(d)	Opinion of Buyer's Counsel
Exhibit 2B(e)	Buyer's Certificate
Exhibit 4M	Purchase and Sales Order Forms

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Seller Debt Schedule
Permitted Encroachments Schedules
Transferred Assets Schedule
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Financial Statements Schedule (§4D)

ALLOYD CO. INC. AND SUBSIDIARIES

Consolidated Interim Financial Statements

October 31, 1989

(Prepared by management without audit)

Alloyd Co. Inc.

Notes to Interim Financial Statements

October 31, 1989

(1) Inventory.

Inventory amounts shown in the interim financial statements are estimated by management using historical and other material cost information. These estimates are adjusted to actual at the end of the year when the company takes a physical inventory of all materials on hand.

(2) Transaction costs due from shareholders.

Certain costs have been incurred in connection with the anticipated sale of the company. The expenses that are not appropriately deductible by the corporation will be reimbursed by the selling shareholders. Analysis and review of these items will occur upon completion of the sale transaction.

(3) Accrued expenses.

It is the company practice to compute certain accrual amounts for employee benefits and other items during the annual audit process. Interim financial statements reflect estimates of management subject to adjustment at year end.

(4) Non-recurring costs.

Costs incurred during the year while the company has been for sale have been separately stated for purposes of this statement.

(5) Corporation income taxes.

Corporation income taxes have been estimated based on the earnings reflected on this interim statement. Transactions anticipated during the sale of the company and operating results for the remaining two months of the year will have an effect on the tax liability as finally determined at the end of the annual accounting year.

Dtd 12/19/89

Alloyd Co. Inc.

Consolidated Statement of Income and Retained Earnings

for the ten months ended

October 31, 1989

Net Sales		$25,610,915
Cost of Goods Manufactured and Sold		16,845,279
Gross profit		$8,765,636
Administrative, selling and engineering		5,119,239
Income from operations		$3,646,397
Other expense:		
Interest	$492,478	
Non-recurring costs (Note 4)	91,195	
Total other expense	$583,673	

Income before income taxes	$3,062,724
Corporation income taxes (Note 5)	1,300,000
Net income for the period	$1,762,724
Retained earnings, beginning of year	7,452,717
Retained earnings, end of period	$9,215,441
Net income adjusted for certain items:	
Corporate income taxes	$1,300,000
Interest	492,478
Officer's compensation-excess	398,560
Non-recurring costs	91,195
	$2,282,233
Net income after taxes	1,762,724
Net income as adjusted	$4,044,957

Dtd 12/19/89

Alloyd Co. Inc.

Interim Balance Sheet

October 31, 1989

ASSETS

Current Assets:	
Cash	$576,998
Accounts receivable, net of customer deposits	3,463,315
Inventory (Note 1)	6,979,277
Prepaid expenses	145,123
Transaction costs, due from shareholders (Note 2)	100,721
Total current assets	$11,265,434
Due from Officer - Shareholder	$44,650
Land, Buildings and Equipment, at cost	$10,927,871
Less - accumulated depreciation	4,555,682
Net land, building and equipment	6,372,189
	$17,682,273

LIABILITIES

Current Liabilities:	
Current portion of Notes payable	$2,600,000
Accounts payable	2,230,546
Accrued expenses (Note 3)	672,251
Officer's compensation	180,934
Accrued taxes, other than income	70,697
Corporate income taxes payable	171,280
Total current liabilities	$5,925,708
Long-term notes payable	$2,493,124
Shareholder equity:	
Common stock	$1,000
Paid-in surplus	47,000
Retained earnings (Exhibit 2)	9,215,441
Total shareholder equity	$ 9,263,441
	$17,682,273

(Note: Interim statements are prepared without audit)

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

ALLOYD COMPANY, INC., et al.)
Plaintiffs,)
)
vs.) No. 91 C 889
ARTHUR L. GUSTAFSON, et al.)
)
Defendants.)

To: The Honorable Ann C. Williams United States District Judge

REPORT AND RECOMMENDATION

Joan H. Lefkow, Executive Magistrate Judge:

* * *

Defendants also point out that the draft section 4D stated that the financial statements "present accurately and completely" the company's financial condition, while the final version says they "present fairly" the company's financial condition.

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(6)

No. 93-404

In The

Supreme Court of the United States

October Term, 1993

ARTHUR L. GUSTAFSON, DANIEL R. McLEAN and FRANCIS I. BUTLER,

Petitioners,

v.

ALLOYD CO., INC. and WIND POINT PARTNERS II, L.P.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

BRIEF FOR PETITIONERS ARTHUR L. GUSTAFSON, DANIEL R. McLEAN AND FRANCIS I. BUTLER

DONALD W. JENKINS*
THOMAS P. DESMOND
JENNIFER R. EVANS
VEDDER, PRICE, KAUFMAN & KAMMHOLZ
222 North LaSalle Street
Chicago, IL 60601
(312) 609-7500

Counsel for Petitioner Arthur L. Gustafson

*Counsel of Record

HAROLD C. WHEELER*
PETER C. WOODFORD
DEBRA A. WINIARSKI
SEYFARTH, SHAW, FAIRWEATHER & GERALDSON
55 East Monroe Street
Chicago, IL 60603
(312) 346-8000

Counsel for Petitioners Daniel R. McLean and Francis I. Butler

*Counsel of Record

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

QUESTION PRESENTED

Whether Section 12(2) of the Securities Act of 1933 extends to a privately negotiated sale of stock.

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On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

BRIEF FOR PETITIONERS ARTHUR L. GUSTAFSON, DANIEL R. McLEAN AND FRANCIS I. BUTLER

Petitioners, Arthur L. Gustafson, Daniel R. McLean and Francis I. Butler, respectfully submit this brief urging reversal of the judgment of the United States Court of Appeals for the Seventh Circuit, entered in this proceeding on June 11, 1993.

OPINIONS BELOW

The order of the United States Court of Appeals for the Seventh Circuit is not reported. It is included in the Joint Appendix ("JA") hereto at p. 8. The opinion of the United States District Court for the Northern District of Illinois is also not reported. It is included at JA 10.

JURISDICTIONAL STATEMENT

Invoking federal jurisdiction under 28 U.S.C. § 1331, Respondents brought suit in the United States District Court for the Northern District of Illinois under the Securities Act of 1933, as amended (the "1933 Act" or the "Act"), 48 Stat. 74, as amended, 15 U.S.C. § 77a *et seq.*, seeking civil relief under Section 12(2) of that Act, 15 U.S.C. § 77l(2) ("Section 12(2)"). On May 29, 1992, the District Court, ruling that Section 12(2) does not apply to the transaction at issue, granted Petitioners' motion for summary judgment.

On Respondents' appeal, the United States Court of Appeals for the Seventh Circuit entered a judgment on June 11, 1993, vacating the District Court's order and remanding this case to the District Court for further proceedings in light of the Seventh Circuit's opinion in *Pacific Dunlop Holdings Inc. v. Allen & Co. Inc.*, 993 F.2d 578 (CA7 1993). This Court's jurisdiction was invoked under 28 U.S.C. § 1254(1) in a Petition filed September 9, 1993. On March 7, 1994 this Court granted the Petition.

STATUTE INVOLVED

This case involves Section 12 of the 1933 Act, 15 U.S.C. § 77l, which is designated "Civil Liabilities Arising in Connection with Prospectuses and Communications" and states:

> Any person who –
>
> (1) offers or sells a security in violation of Section 77e of this title [Section 5], or
>
> (2) offers or sells a security (whether or not exempted by the provisions of 77c of this title [Section 3], other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

STATEMENT OF THE CASE

This case arises out of Petitioners ("Sellers") December 1989 sale of Alloyd Co., Inc. ("Alloyd") to Respondent Alloyd Co., Inc. (then named Alloyd Holdings, Inc. ("Holdings")). The sale was effectuated by Holdings' acquisition of all of Alloyd's outstanding stock pursuant to a comprehensive privately negotiated stock purchase agreement (the "Stock Purchase Agreement"). JA 87. Respondents Holdings and Wind Point Partners II, L.P. ("Wind Point") (collectively "Buyers") claim that material misrepresentations were made in the Stock Purchase Agreement and in oral communications in connection with that sale which entitle them to rescind the sale pursuant to Section 12(2). Amended Complaint at ¶¶ 34-35, JA 23.

Alloyd was a manufacturer of clear plastic blister packaging and automatic heat seal packaging equipment whose stock had been outstanding since 1961. In 1989, Sellers, who were Alloyd's sole shareholders (Gustafson 85%, McLean 10% and Butler 5%), decided to sell Alloyd. Wind Point, an experienced and sophisticated venture capital investment partnership, expressed interest in buying Alloyd. After conducting extensive due diligence regarding Alloyd, visiting Alloyd's facility and interviewing key Alloyd officers and employees, Wind Point offered to purchase Alloyd. JA 11 and 14. Sellers agreed to sell Alloyd to Holdings, a corporation formed by Wind Point to effectuate the purchase. Sellers McLean and Butler reinvested in Alloyd and became officers and directors of the new company. JA 11.

The provisions of the Stock Purchase Agreement were negotiated over several weeks. During the negotiations, Buyers conducted extensive due diligence regarding Alloyd and retained KPMG Peat Marwick ("KPMG") to conduct a formal business review of Alloyd. JA 11. As part of its review, KPMG noted that the inventory shown on Alloyd's interim financial statements was estimated and discussed with Buyers the appropriateness of taking a physical inventory. JA 11. No physical inventory was taken prior to closing. JA 11. Buyers initially sought a representation that Alloyd's financial statements presented Alloyd's financial condition "accurately and completely." Buyers ultimately agreed to a representation, which cautioned that inventory and certain accrued expenses were estimated on an interim basis and subject to adjustment at year-end, that the financial statements "present fairly" Alloyd's financial condition. JA 171, JA 115 at ¶ 4D, and JA 164.

The Stock Purchase Agreement was executed as of December 20, 1989 and the transaction closed on December 22, 1989, when Holdings purchased Sellers' stock for $18,709,000 plus a payment of $2,122,219, reflecting an estimate of Alloyd's increase in net worth from December 31, 1988 through the closing. JA 12. A provision in the Agreement required that, after the year-end audit of Alloyd's financial statements, Sellers or Buyers would remit an appropriate amount to cover any variance between the estimated increase in Alloyd's net worth and the actual increase. JA 12. After KPMG audited Alloyd's December 31, 1989 financial statements, Sellers paid

Holdings $815,000 plus interest pursuant to that provision, due in large part to an audit adjustment made to reflect Alloyd's actual inventory at year end. JA 12.

Among many other provisions, the Stock Purchase Agreement provided that Buyers would make no liability claim against Sellers unless their damage exceeded certain dollar amounts (sometimes referred to as "baskets"), JA 145 at ¶ 7B; that Buyers were sophisticated investors who would not engage in any distribution of Alloyd stock, JA 143 at ¶ 5H; that Buyers believed they had all their questions answered, JA 143 at ¶ 5H; that Buyers knew of no fact or circumstance that would make any of Sellers' representations and warranties untrue, JA 143 at ¶ 5I; and that Buyers expressly waived any rescission remedy, JA 148 at ¶ 7B(c).

On February 11, 1991, Buyers filed this case seeking rescission of their purchase of Alloyd pursuant to Section 12(2). They alleged that Alloyd's earnings were overstated in 1989 interim financial statements, claiming Alloyd's actual inventory was lower than presented in those financial statements. Buyers also alleged that oral misrepresentations were made regarding Alloyd's interim earnings. JA 23 at ¶¶ 24, 35.

The District Court's May 29, 1992 Memorandum Opinion and Order granted Sellers' motion for summary judgment as to Buyers' Section 12(2) claim, relying heavily on the reasoning in *Ballay v. Legg Mason Wood Walker*, 925 F.2d 682 (CA3), *cert. denied*, 112 U.S. 79 (1991). The District Court concluded that the privately negotiated transaction at issue in this case could not be compared to a new offering because, unlike purchasers in

most initial offerings, Buyers had direct access to financial and other information about Alloyd. JA 21.

Buyers appealed to the Seventh Circuit which, on June 11, 1993, vacated without opinion the District Court's Order and remanded the case for further consideration in light of its holding in *Pacific Dunlop*, 993 F.2d 578. JA 8.

SUMMARY OF ARGUMENT

The proper application of Section 12(2) should be determined in light of its language in the context of the 1933 Act, the structure of the Act, the evils the Act sought to cure and the overall policy of the Act. The 1933 Act was passed to prohibit solicitation of public investors based on incomplete or misleading information in prospectuses and other selling communications. The 1933 Act does so by regulating the process by which securities are offered to the public and specifying the information that must be provided before securities can be sold to the public. It provides remedies to buyers when unregistered offerings of securities are made to the public and when securities are sold to the public by means of a false or misleading registration statement, prospectus or other selling communication.

The Act was also intended, however, to interfere as little as possible with private business. By the exemptions it includes relating to transactions not involving any public offerings, the 1933 Act accomplished that purpose.

Persons selling securities by means of a misleading "prospectus or oral communication" are liable under Section 12(2) to purchasers for rescission or rescissionary damages. The Section's use of "prospectus" demonstrates it was intended to apply only in the context of sales of stock to the public, the type of transaction intended to be covered by the 1933 Act. A privately negotiated agreement to sell a company does not comport with any obvious meaning of the word "prospectus." Rather, a privately negotiated stock purchase agreement sets forth, usually after extensive due diligence by the buyer, the negotiated terms upon which a purchase of stock will take place, frequently including agreed allocation of risks relating to matters that are not certain.

The Section 12(2) cause of action and remedy is more akin to an action for breach of fiduciary duty than to an action based on fraud under Section 10(b) of the Securities and Exchange Act of 1934, as amended (the "1934 Act"), 48 Stat. 881, as amended, 15 U.S.C. § 78j(b). Such a powerful remedy for a buyer is appropriate in the context of solicitation of the public to purchase securities because the Act imposes upon those engaged in such solicitation an affirmative duty of full and fair disclosure. Such relief, however, has no proper place in a privately negotiated transaction where terms are negotiated, warranties are made, risks are allocated, and there is full access to information and both parties have bargaining power. It would be poor public policy to extend Section 12(2) to cover such negotiated transactions.

Here Sellers sold all the stock of a company to sophisticated Buyers. If Sellers breached the Stock Purchase Agreement, Buyers have a contractual remedy. If

Sellers committed fraud (which Buyers have never claimed), Buyers would have had a remedy under common law or the 1934 Act. There is no basis in the language, context or purpose of Section 12(2) for extending its fiduciary duty-based standard of liability to Buyers in this case. Petitioners respectfully request that this Court vacate the Seventh Circuit's Order and affirm the District Court's grant of summary judgment for Petitioners as to Respondents' Section 12(2) claims.

ARGUMENT

I. INTRODUCTION

A. The Competing Policies At Issue

The March 29, 1933 "Message from the President – Regulation of Security Issues" recommending the 1933 Act made clear that the legislation was aimed at requiring fair disclosure in connection with the sale of securities to the public:

> I recommend to the Congress legislation for Federal supervision of **traffic** in investment securities in interstate commerce. In spite of many State statutes the **public** in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations **selling securities**. Of course the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.

> There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed **from the buying public**.

S. Rep. No. 47, 73rd Congress, 1st Sess. (1933) (the "Senate Report"), at 1-2 (emphasis added).

The Message from the President also emphasized, however, that the aim to protect the public would be achieved with the "**least possible interference**" with honest business. Senate Report at p. 1. There is obvious tension between the goal of regulation and the concurrent goal of preservation of business freedom. How the Act reconciled these is central to the issue before this Court. As James Landis, a principal drafter of the 1933 Act, has explained (referencing discussions with Middleton Beaman, for many years the chief legislative draftsman for the House of Representatives):

> [Beaman] insisted instead on exploring the implications of the bill to find exactly what we had or did not have in mind. He probed always for the extent and nature of those hiatuses that any proposed important legislation necessarily possesses. . . . It was these discussions that first evolved the exact scope that we wanted the Securities Act to cover. "Public offerings" as distinguished from "private offerings" proved to be the answer. The sale of an issue of securities to insurance companies or to a limited group of experienced investors, was certainly not a matter of concern to the federal government.

Landis, *The Legislative History of the 1933 Securities Act*, 28 Geo. Wash. L. Rev. 29, 36-37 (1959).

The tension between these goals was reconciled by inclusion of the transaction exemptions of Section 4 of the 1933 Act (15 U.S.C. § 77d) which exempted, among other things, transactions "not involving any public offering." Referring to this exemption, this Court stated in *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124-25 (1953) (footnote omitted):

> Exemption from the registration requirements of the Securities Act is the question. The design of the statute is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions. The natural way to interpret the private offering exemption is in light of the statutory purpose. Since exempt transactions are those as to which 'there is no practical need for * * * [the bill's] application,' the applicability of § 4(1) should turn on whether the particular class of persons affected need the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'

Whether a Section 12(2) remedy applies to privately negotiated transactions that Section 4 exempts from the registration requirements of Section 5 of the 1933 Act (15 U.S.C. § 77e) has never been decided by this Court and Courts of Appeal are in conflict on this issue.

In *Landreth Timber Company v. Landreth*, 471 U.S. 681 (1985), this Court dealt with an analogous issue when it determined that a private sale of all the outstanding stock of a company involved the sale of a "security" within the

meaning of the 1934 Act. Unlike the 1933 Act, however, the 1934 Act has no private offering exemption, as the Court specifically noted. *Id.* at 692. In *Landreth*, the transaction involved was preceded by comprehensive negotiations between the buyer and seller and there was no suggestion that the buyers were unable to obtain appropriate warranties or independently evaluate relevant information before entering into the transactions. Justice Stevens, dissenting, did not believe that the 1934 Act covered the private transaction, stating: "I believe that Congress wanted to protect investors who do not have access to inside information and who are not in a position to protect themselves from fraud by obtaining appropriate contractual warranties." *Id.* at 698-702 (footnotes omitted). As demonstrated below, Justice Stevens' reasoning is irrefutably applicable to this privately negotiated transaction in light of the exemption of Section 4(2) of the 1933 Act.

B. Prior Decisions By Courts Of Appeals

Prior to *Ballay* and *Pacific Dunlop*, the few Courts of Appeals addressing whether Section 12(2) applied to private transactions had reached differing conclusions.[1] In

[1] *See Cady v. Murphy*, 113 F.2d 988 (CA1), *cert. denied*, 311 U.S. 705 (1940) (upheld a Section 12(2) claim where the sale involved outstanding stock, though neither the parties nor the court directly addressed whether Section 12(2) extended to private transactions); *Woodward v. Wright*, 266 F.2d 108 (CA10 1959) (upheld a Section 12(2) claim in a secondary transaction without addressing whether 12(2) applied to private transactions); *Nor-Tex Agencies, Inc. v. Jones*, 482 F.2d 1093 (CA5 1973), *cert. denied*, 415 U.S. 977 (1974) (held that the private intrastate sale of a fractional undivided oil and gas interest was within the scope of

1991, the Third Circuit Court of Appeals in *Ballay*, addressed whether a brokerage firm's communications relating to a public market transaction were within the scope of Section 12(2). The Court analyzed the language of Section 12(2), the structure and legislative history of the 1933 Act and relevant policy considerations and concluded that Section 12(2) does not apply to secondary market transactions. The *Ballay* court found that the phrase "by means of a prospectus or oral communication" in Section 12(2) reflected Congress's intention to limit the Section's reach to initial public distributions because the term "prospectus" as used in Section 12(2) was intended to refer to a formal prospectus associated with an offering to the public. Applying the principle *noscitur a sociis* (discussed more fully below), the Court concluded that the term "oral communication" in Section 12(2) was meant to refer to oral communications made in connection with a prospectus, stating: "We believe Congress employed the term 'prospectus' as a term of art

Section 12(2) because such a transaction was not expressly exempted from the 1933 Act but did not analyze whether Section 12(2) reached such a transaction); *Haralson v. E.F. Hutton Group, Inc.*, 919 F.2d 1014 (CA5 1991) (summarily rejected a contention that Section 12(2) applied only to public offerings relying solely on *Nor-Tex Agencies*). *But see Gross v. Diversified Mortgage Investors*, 431 F. Supp. 1080 (S.D.N.Y. 1977), *aff'd mem.*, 636 F.2d 1201 (CA2 1980) (affirmed the district court's dismissal of a Section 12(2) claim based on a secondary market transaction because Section 12(2) only protects purchasers of stock sold pursuant to a misleading prospectus, which the court found is only used with respect to an initial offering). District courts too numerous to cite are in conflict on this issue, although the vast majority follow the reasoning of *Ballay* or some close variation thereof.

which describes the transmittal of information concerning the sale of a security in an initial distribution." *Id.* at 688. If Congress had intended a more expansive meaning for Section 12(2), it "more simply could have drafted Section 12 to govern all written or oral communications." *Id.* at 689. *See also First Union Discount Brokerage Services, Inc. v. Milos*, 997 F.2d 835 (CA11 1993) (following *Ballay's* reasoning and conclusion).

A 1992 article by Professor Elliot Weiss expanded and refined the *Ballay* court's argument and concluded that *Ballay* was essentially correct, but that Section 12(2) only applies to offerings "that are registered, should be registered, or are not registered solely because they involve securities that Section 3 exempts from registration." Weiss, *The Courts Have it Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 Bus. Law. 1, 4 (1992).[2] Other legal scholars have reached different conclusions.[3]

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[2] *See also*, Prentice, *Section 12(2): A Remedy for Wrongs in the Secondary Market?*, 55 Alb. L. Rev. 97 (1991). Professor Weiss argues that the first case treating this issue, *Moore v. Gorman*, 75 F. Supp. 453 (S.D.N.Y. 1948), was based on flawed research and faulty reasoning. Because Professor Loss cited the case as authority in the first edition of his influential treatise, *Securities Regulation*, this misguided view gradually gained momentum until recently. *Weiss* at 28.

[3] L. Loss, *The Assault on Securities Act Section 12(2)*, 105 Harv. L. Rev. 908 (1992); L. Loss, *Securities Act Section 12(2): A Rebuttal*, 48 Bus. Law. 47 (1992); and Maynard, *Liability Under Section 12(2) of the Securities Act of 1933 for Fraudulent Trading in Post Distribution Markets*, 32 Wm. & Mary L. Rev. 847 (1991) (claiming Section 12(2) extends to private transactions). *See also* Hirsh, *Applying Section 12(2) of the 1933 Securities Act to the Aftermarket*, 57 U. Chi. L. Rev. 955, 963 (1990).

The Seventh Circuit reached a conclusion totally contrary to *Ballay* in *Pacific Dunlop*, construing "prospectus" as defined in Section 2(10) of the 1933 Act to include all written communications in connection with sales of securities, the definition it believed was meant to apply in Section 12(2). Accordingly it held that a private sale pursuant to a stock purchase agreement was covered by Section 12(2) because the agreement itself was a "prospectus." As discussed below, the Seventh Circuit failed to recognize the limiting nature of the phrase "by means of a prospectus or oral communication" as used in Section 12(2), which shows that Section 12(2) only applies in a public offering and does not refer to a privately negotiated sale of stock. A prospectus is prepared by the person or entity making a public offering as a selling device to persuade the public to purchase securities. A stock purchase agreement is quite distinct. It is negotiated by a buyer and seller, each able to fend for itself. It is not used to solicit a transaction, but rather to reflect the terms upon which the parties agree to enter into a business transaction. A prospectus is the subject of the primary objectives of the 1933 Act. A privately negotiated agreement is not.

The Seventh Circuit also appears to have failed to recognize or properly consider the unique fiduciary nature of the liability created by Section 12(2). It appears to regard the Section as simply another "antifraud provision." *Pacific Dunlop*, 993 F.2d at 594. Plainly, as discussed below, Section 12(2) is more than that because of its fiduciary based remedy and its imposition of the burden of proof on the seller. Regarding Section 12(2) as an antifraud remedy, the Seventh Circuit erroneously relied

on legislative history concerning Section 17(a) of the Act (which is an antifraud provision) as if it were applicable to Section 12(2).

The Seventh Circuit's conclusion that Section 12(2) applies to privately negotiated transactions was erroneous. It is not warranted by the language, structure or legislative history of the 1933 Act, all of which demonstrate that Section 12(2) applies to public offerings of securities and does not extend, and was not intended to extend, to privately negotiated sales of stock.

II. THE LANGUAGE AND STRUCTURE OF THE 1933 ACT DEMONSTRATE THAT SECTION 12(2) APPLIES TO PUBLIC – NOT PRIVATE – SALES OF STOCK

A. Principles Of Statutory Construction

The starting point in every case involving statutory construction is the statutory language. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197, *reh'g denied*, 425 U.S. 986 (1976); *Pinter v. Dahl*, 486 U.S. 622, 641 (1988). A remedial section must be read in the context of its placement in the statute and in comparison to the statute's other remedial provisions giving consideration to the object and structure of the statute as a whole. *Dole v. United Steel Workers of America*, 494 U.S. 26, 36 (1990); *Pilot Life Ins. Co. v. Dedeaux*, 481 U.S. 41, 51 (1987) ("[B]eyond the letter of the statute is the evil sought to be remedied, which is always significant in determining the meaning"); *Durland v. United States*, 161 U.S. 306, 313 (1896); *Apex Hosiery Co. v. Leader*, 310 U.S. 469, 489 (1940); *Crandon v. United States*, 494 U.S. 152, 168 (1990).

As stated in *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 594-95 (1973): "[T]he courts have come to inquire whether the transaction may serve as a vehicle for the evil which Congress sought to prevent . . . thereby endeavoring to implement congressional objectives **without extending the reach of the statute beyond its intended limits**." (emphasis added).

B. "Prospectus" As Used In The 1933 Act Means A Communication Soliciting The Public To Purchase Securities

Section 12(2) of the 1933 Act provides that every person who sells securities "by means of a prospectus or oral communication" that contains a materially false or misleading statement shall be liable to the person who purchased those securities for rescission or rescissionary damages. The question before this Court is whether Congress intended to subject sellers of securities in privately negotiated transactions to this stringent liability provision. To answer that question, this Court must decide the meaning of the phrase "by means of a prospectus or oral communication" as used in Section 12(2).

Plain English and established principles of statutory construction show that the phrase "by means of a prospectus or oral communication" limits the scope of Section 12(2) to sales made by means of documents that solicit investments from public investors and oral communications that relate to such documents. The word "prospectus" has, and in 1933, had, this well-established meaning. Black, *A Law Dictionary* 959 (2d ed. 1910) defined "prospectus" as:

A document published by a company or corporation, or by persons acting as its agents or assignees, setting forth the nature and objects of an issue of shares, debentures or other securities created by the company or corporation, *and inviting the public to subscribe to the issue.*

(emphasis added).

That Congress intended the word "prospectus" in Section 12(2) to be read in this generally accepted sense is evident from the purpose and legislative history of the 1933 Act. As stated in *Ernst & Ernst v. Hochfelder*, 425 U.S. at 195, the 1933 Act "was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce. . . . " *See also Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 752, *reh'g denied*, 423 U.S. 884 (1975) (The 1933 Act is "chiefly concerned with disclosure and fraud in connection with offerings of securities – primarily, as here, initial distributions of newly issued stock from corporate issuers."); *United States v. Naftalin*, 441 U.S. 768, 777-78 (1979) (the 1933 Act was "primarily concerned with the regulation of new offerings").

The House Report regarding H.R. 5480, H. Rep. No. 85, 73d Cong., 1st Sess. (1933) (the "House Report") made it clear that a prospectus was a selling document (and that the private remedies under Sections 11 and 12 were to afford relief to those who purchased securities as part of a public distribution) stating:

The committee emphasizes that these liabilities attach only when there has been an untrue statement of material fact or an omission to state a material fact in the registration statement or the

prospectus – the basic information by which the public is solicited.

House Report at 9 (emphasis added).

As shown more fully below, Congress made it abundantly clear that, with the singular exception of Section 17(a), 15 U.S.C. 77q(a), the 1933 Act was directed at regulating public offerings of securities. The 73rd Congress was equally clear that private transactions between sophisticated parties – such as the transaction involved in the instant case – are beyond the scope of the 1933 Act.

Section 2(10) of the 1933 Act defines various terms used in the Act stating:

"[U]nless the context otherwise requires[4] . . . The term "prospectus" means any prospectus, notice, circular, advertisement, letter or communication, written or by radio or television, which offers a security for sale or confirms the sale of the security . . . "

15 U.S.C. § 77b(10).[5] It is well-established that words grouped in a list should be given related meaning. As

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[4] Referring to this "context" phrase, this Court has noted that "Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws." *SEC v. National Securities, Inc.*, 393 U.S. 453, 466 (1969).

[5] The words "confirms the sale of any security" do not broadly expand the definition of "prospectus." Congress was using the word "confirm" not generally but as a term of art to refer to brokers' confirmations only. This Court has repeatedly held that literal interpretation should not overcome common sense or plain statutory purpose. In *Marine Bank v. Weaver*, 455 U.S. 551, 558-59 (1982), this Court, relying upon the "context clause" in the 1934 Act which is identical to that in the 1933 Act,

explained in *Jarecki v. G.D.Searle & Co.*, 367 U.S. 303, 307 (1961): "[T]he maxim *noscitur a sociis*, that a word is known by the company it keeps, while not an inescapable rule, is often applied where a word is capable of many meanings **in order to avoid giving unintended breadth to Acts of Congress**." (emphasis added). The list of communications set forth in Section 2(10) should be read in this fashion, and can easily be so read. That is, Congress drafted the definition so that the only written (or broadcast) communications that qualify as a "prospectus" are the circular(s), advertisement(s), letter(s) or other communication(s) that, like a "prospectus," solicit the

see 15 U.S.C. § 78c, held that a bank's certificate of deposit was not a "security" under the 1934 Act even though the certificate fit within the literal definition of a security because it was unnecessary to subject the issuers of such certificates, the holders of which were abundantly protected by the federal banking laws, to liability under the antifraud provisions of the federal securities laws. In *Reves v. Ernst & Young*, 494 U.S. 56, 63 (1990), this Court determined that not every note was a "security" for purposes of the 1934 Act even though the 1934 Act's definition of security included the phrase "any note" because the phrase "must be understood against the backdrop of what Congress was attempting to accomplish in enacting the Securities Acts." *See also Byrnes v. Faulkner, Dawkins & Sullivan*, 550 F.2d 1303, 1310 (CA2 1977) ("Section 2(10) [of the 1933 Act] need not literally apply if reason indicates otherwise."). As the Seventh Circuit observed in *Sutter v. Groen*, 687 F.2d 197, 200 (CA7 1982), the *Marine Bank* Court treated "the word context in the introductory clause of Section 3(a)(10) [of the 1934 Act] as having reference to the economic as well as linguistic context." *See* H. Rep. No. 1542, 83d Cong., 2d Sess. (1954).

public to purchase securities.[6] Communications – and particularly privately negotiated agreements – that do not serve that function are not included.

So reading Section 2(10) makes sense of Section 12(2) which, by including the phrase "by means of a prospectus or oral communication" defines the scope of the Section's application – to public offerings. Congress could have expanded the scope of Section 12(2) by simply stating it applied to sales by means of "any communication." It did not. This Court has observed that a statute should be read so as "to give effect, if possible, to every clause and word . . ." *United States v. Menasche*, 348 U.S. 528, 538-39 (1955) (quoting *Montclair v. Ramsdell*, 107 U.S. 147, 152 (1882)). *See also Reves v. Ernst & Young*, 494 U.S. 56, 63 (1990) (rejecting a proffered interpretation of the word "conduct" in RICO that would have rendered that word superfluous). *Compare* Uniform Securities Act § 410(a)(2), 7B U.L.A. 643 (1985), which is intended to apply to all sales of securities, and which tracks Section 12(2) in all material respects except that it contains no reference to "by means of a prospectus or oral communication." If the

[6] As stated by Sen. Fletcher: "People have been persuaded to invest their money in securities without any information respecting them, except the advertisements put forth by the agents or representatives of those issuing the securities, and such advertisements have not given full information **to the public**." 77 Cong. Rec. 2982 (1933) (emphasis added). Rep. Bulwinkle stated: "[N]early everyone has read those lurid advertisements issued by American concerns advising the **American public** to purchase these securities." *Id.* at 2924 (emphasis added).

phrase "by means of a prospectus or oral communication" is to be given any effect, one must read Section 12(2) as applicable to some, but not all, sales of securities. The intended effect, given the language use and the purpose of the 1933 Act, was to limit Section 12(2) to public sales of stock.

Buyers, relying on *Pacific Dunlop,* maintain that the Section 2(10) definition of the term "prospectus" means any written communication that offers a security for sale or confirms the sale of a security. This, coupled with the inclusion of "or oral communication" in Section 12(2), means – Buyers assert – that Section 12(2) applies to **every** sale of a security, since every such sale involves some oral or written communication.

In Section 12(2), Congress used the term "prospectus" in its usual and customary sense, as a reference to a document that solicits public investors to purchase securities.[7] The Stock Purchase Agreement is simply not a prospectus. *See Marine Bank v. Weaver*, 455 U.S. at 551, 560 (1982), determining that a privately negotiated agreement

[7] As the House Report states at 8:

> Any objection that the compulsory incorporation **in selling literature and sales argument** [solicitation] of substantially all information concerning the issue, will frighten the buyer with the intricacy of the transaction, states one of the best arguments for the provision. The **rank and file of securities buyers** who have hitherto bought blindly should be made aware that securities are intricate merchandise.

(emphasis added). Sophisticated purchasers in negotiated private transactions are certainly not such "rank and file" and do not require the described protection.

among businessmen to share profits was not a security, noting that the sellers distributed no "prospectus" plainly implying that the agreement itself was not a prospectus.

The 1933 Act as a whole establishes an intricate and comprehensive regulation of the method of disseminating as well as the substance of, information as offerings are made to the public.[8] Pursuant to Section 5 of the 1933 Act, a person may not, absent an appropriate exemption, offer or sell a security to the public without filing a registration statement. *See A.C. Frost & Co. v. Coeur D'Alene Mines Corp.*, 312 U.S. 38, 43 (1941). As this Court observed in *Pinter v. Dahl*, 486 U.S. at 638:

> The registration requirements are the heart of the Act, and § 12(1) imposes strict liability for violating those requirements. Liability under § 12(1) is a particularly important enforcement tool, because in many instances a private suit is the only effective means of detecting and deterring a seller's wrongful failure to register securities before offering them for sale.

[8] As stated by Rep. Mapes:

> The object of the legislation, in brief, is to require those who issue securities **to be sold to the public** through the mails or by the use of the instruments of interstate commerce to furnish material information **to the public about the securities which they are asking the public to buy**. That, in my judgment, will be the chief and primary accomplishment of the legislation. **It will make available to the public the information upon which the public is asked to invest its money.**

77 Cong. Rec. 2912 (1933) (emphasis added).

The registration and prospectus dissemination requirements of the 1933 Act focus exclusively on public offerings and have no applicability to privately negotiated transactions. While space here does not permit a detailed description of how the Act requires and regulates dissemination of information in a public offering, that description is set forth in detail in *Weiss, supra* at 9-12. Plainly a privately negotiated stock purchase agreement plays no intended role in that statutory scheme.

In sum, the 73rd Congress was seeking to regulate numerous prospectuses, advertisements and other communications directed toward the public which had been the cause of the public being misled. Congress was not concerned, and did not want to interfere, with the thousands of privately negotiated transactions involving sophisticated parties able to fend for themselves. The 1933 Act's overall structure demonstrates most convincingly that the phrase "prospectus" in Section 12(2) connotes selling literature in connection with an offering of securities to the public – and not "any communication" in a privately negotiated transaction.

This Court should reject Buyers' assertion that "prospectus" in Section 12(2) means "any written communication" which makes the word superfluous because doing so will be "extending the reach of the statute beyond its intended limits." *Kern County Land Co.* 411 U.S. 582.

C. The Type Of Remedy Afforded By Section 12(2) Connotes Application To Public – Not Private – Sales of Stock

The private remedies in the 1933 Act are designed to compel compliance with the Act's mandatory disclosure requirements relating to offerings of securities to the public. As stated in *Randall v. Loftsgaarden*, 478 U.S. 647, 659 (1986), "Congress chose a rescissory remedy when it enacted § 12(2) in order to deter prospectus fraud and encourage full disclosure. . . . " Section 12(2) represents a drastic and fundamental change in the common law but only as to transactions involving solicitation of "other people's money" in public offerings of stock through prospectuses and similar types of selling communications. Under Section 12(2), a plaintiff need not show scienter, reliance or causation. The standard for liability is negligence, and the statute imposes upon a seller the burden of proof in establishing his freedom from such negligence.

The House Report, at 5, states as follows regarding the civil liabilities imposed by the Act: "Their essential characteristic consists of a requirement that all those responsible for statements upon the face of which the **public is solicited** to invest its money shall be held to standards **like those imposed by law upon a fiduciary**" (emphasis added). The Report later explained that, where selling statements are made to the public, the persons making the statements are liable not only if they cannot prove they did not know of "the flaw in the information **offered to the public**," but also if they cannot prove that they could not have found the flaw and that they believed the information provided was true. Explaining

this burden of proof, the Report stated: "Unless responsibility is to involve merely paper liability it is necessary to throw the burden of disproving responsibility for reprehensible acts of omission or commission on those who purport to issue statements **for the public's reliance."** *Id.* at 9 (emphasis added). As stated by Sen. Fletcher, "All **publicity** which induces the public to invest should carry with it an obligation of personal liability for the facts stated." 77 Cong. Rec. 3233 (1933) (emphasis added).

The House Report acknowledges that, under Section 12(2), a purchaser may recover based upon a misrepresentation in a prospectus which the buyer may never have seen. *Id.* at 10. The justification given by the Report for allowing this extraordinary remedy presupposes that an action brought under Section 12(2) will arise in the context of a public distribution:

> The statements for which [persons] are responsible, although [the statements] may never actually have been seen by the prospective purchaser, **because of their wide dissemination**, determine the market price of the security, which in the last analysis reflects those manifold causes that are the impelling motive of the particular purchase. The connection between the statements made and the purchase of the security is clear, and, for this reason, it is the essence of fairness to insist upon the assumption of responsibility for the making of these statements.

Id. (emphasis added). Plainly as to private sales of stock, where there is no such "wide dissemination" and no "market price," Congress did not contemplate liability under Section 12(2).

A seller of securities in an offering to the public should bear liability for rescission or rescissionary damages because the seller receives the full purchase price from the buyer and is generally the buyer's sole source of information concerning the value, risk, and quality of the security. The fiduciary duty based remedy of Section 12(2) is consistent with the congressional purpose of regulating and promoting full disclosure in public distributions and penalizing those failing to comply by forcing disgorgement of the entire amount the seller received irrespective of the damages actually suffered by the buyer.

That Section 12(2) applies only to solicitations of the public is also evidenced by the fact that it only protects a buyer. In the context of public offerings, a remedy solely for buyers makes complete sense because buyers injured by misinformation in selling communications require a statutory remedy since they have no contractual protection. In contrast, in a privately negotiated transaction, a buyer has the ability to demand access to information and negotiate the terms of the purchase. In such transactions, a fiduciary duty based standard of liability and related rescission remedy imposed only on buyers simply makes no sense. Fraud or breach of contract remedies should be available to each party to such a transaction to compensate for any actual loss sustained. *See* Sections 10(b) and 18(a) of the 1934 Act and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1992).

Unlike a purchaser in the context of a public offering, a private buyer has a direct agreement with the seller, oral or written, upon which the buyer can base his claims. Neither the 1933 Act nor its legislative history purports to

justify imposition of the strict Section 12(2) standard of liability in privately negotiated transactions. If Congress intended to change so drastically the fundamental relationship between sellers and buyers in private transactions it undoubtedly would have said so. That Congress did not shows that it never contemplated, much less intended, that Section 12(2) would apply to privately negotiated sales.[9]

D. Comparison Of The Section 12(2) Remedy To Other Remedies Shows It Applies To Public – Not Private – Sales Of Stock

As stated in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206 (1976) (quoting *SEC v. National Securities, Inc.*, 393 U.S. 453, 466 (1969)), "interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen. . . . " To interpret "prospectus" as limited to documents that solicit the public to purchase securities is entirely consistent with the Act's liability scheme.

The Act contains two civil liability sections, Sections 11 and 12. Section 11, 15 U.S.C. § 77k, imposes "the high standards of trusteeship" on those with greatest responsibility for public offerings and thereby promotes the integrity of the information included in registration statements. If a registration statement contains a false or

[9] As explained in *Chisom v. Roemer*, 501 U.S. 380, n. 23 (1991) and *Church of Scientology v. I.R.S.*, 484 U.S. 9, 17-18 (1987), absence of supporting legislative history in this context is analogous to the "dog that did not bark" referenced in Arthur Conan Doyle, *Silver Blaze*, Complete Sherlock Holmes 335 (1927).

misleading statement of material fact, the issuer is strictly liable under Section 11 for losses incurred by those who purchased the securities the statement covers. Others with responsibility for the offering – including the officers who signed the registration statement, the issuer's directors, and those who underwrote the offering – are also liable unless they establish that they exercised due diligence, including making a reasonable investigation, to ensure that the registration statement contained no material misrepresentations. *See Ernst & Ernst v. Hochfelder*, 425 U.S. at 208-210.

Section 12(1) is the Act's most basic liability provision. It ensures compliance with the Act's registration and information dissemination requirements by making any person who offers or sells a security in violation of Section 5 strictly liable for rescission. Section 12(2) rounds out the Act's liability provisions by imposing liability on persons who make misrepresentations by means of a prospectus or related oral communications. Given its position as a subsection in Section 12, and particularly its use of "prospectus," Section 12(2) cannot reasonably be construed as applicable to private transactions while the closely related Section 12(1) plainly applies only to public offerings. Without Section 12(2), significant gaps would exist in the statutory scheme, and purchasers victimized by sellers' misrepresentations in a number of settings, all involving public offerings, might otherwise have no remedy. *See Byrnes v. Faulkner, Dawkins & Sullivan*, 413 F. Supp. 453 (S.D.N.Y. 1976), *aff'd*, 550 F.2d 1303 (CA2 1977) (discussing the relationship and separate functions of Sections 12(1) and 12(2) assuming both related to public distributions of securities).

First, Section 12(2) creates a remedy against a seller who has used materially false or misleading statements to sell securities in unregistered public offerings when a Section 12(1) claim might be barred by the applicable statute of limitations.[10] Section 12(2) also supplements Section 11 by adding a remedy against dealers with respect to statutory prospectuses and against all persons who sell securities in registered public offerings by means of materially false or misleading oral statements not prohibited by Section 5.[11] Moreover, Section 12(2) creates a remedy against all sellers, including issuers, underwriters and dealers, who make materially false or misleading statements in connection with a public offering of securities (other than securities exempted by Section 3(a)(2), 15 U.S.C. § 77c(a)(2)) that are exempted from registration by Section 3. This allows purchasers to recover when sellers misrepresent material facts in connection with public offerings effectuated, for example,

[10] A buyer in such an offering must bring a Section 12(1) claim within one year of the violation. Section 13, 15 U.S.C. § 77m. Section 12(2), in combination with Section 13, however, allows a purchaser a longer period to discover he has been defrauded before his action will be time-barred. Purchasers have had occasion to rely on Section 12(2) for protection in just such situations. *See MacClain v. Bules*, 275 F.2d 431, 437 (CA8 1960); *Stone v. Fossill Oil & Gas*, 657 F. Supp. 1449, 1457-58 (D.N.M. 1987); *Woods v. Home & Structures, Inc.*, 489 F. Supp. 1270, 1289 (D. Kan. 1980); *Felts v. National Accounts Sys. Ass'n, Inc.*, 469 F. Supp. 54, 64 (N.D. Miss. 1979).

[11] Section 11 creates no liability for dealers, see William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 Yale L.J. 171, 208 (1933), and creates liability for issuers, underwriters and others responsible for registered offerings only with respect to misrepresentations in the registration statement.

pursuant to Regulation A, Regulation B or the intrastate offering exemption.[12] In sum, the role of Section 12(2) in the scheme of the 1933 Act was to complement Section 12(1) in imposing liability as to all types of solicitations of the public to purchase securities.

That Section 12(2) was not intended to apply to privately negotiated sales is also demonstrated by a comparison with the language of Section 17 of the 1933 Act which makes it unlawful "directly or indirectly" to obtain money or property by means of any untrue statement in the sale of a security. 15 U.S.C. § 77q. This language differs greatly from the phrase "offers or sells . . . by means of a prospectus or oral communication" used in Section 12(2). In *United States v. Naftalin*, 441 U.S. at 778, this Court observed that Section 17 was "[u]nlike much of the rest of the [1933] Act," in that it was intended to cover any scheme to defraud "whether in the course of an initial distribution or in the course of ordinary market trading." The Court's conclusion relied heavily upon statements made in the Senate and House Reports which, unlike the legislative history of Section 12(2), explicitly demonstrated an intention to apply Section 17 to transactions in both the primary and secondary securities market.

[12] *See Globus v. Law Research Serv., Inc.*, 287 F. Supp. 188 (S.D.N.Y. 1968), *aff'd in part and rev'd in part*, 418 F.2d 1276 (CA2 1969), *cert. denied* 397 U.S. 913 (1970); *Dale v. Rosenfeld*, 229 F.2d 855 (CA2 1956); *Pawgan v. Silsenstein*, 265 F. Supp. 898 (S.D.N.Y. 1967).

Finally, that the 1934 Act created broad fraud remedies for buyers (as well as sellers) in connection with private (as well as public) sales of stock, is perhaps the strongest affirmation that Congress did not believe Section 12(2) – a better remedy for buyers than the fraud remedy in the 1934 Act – applied to private sales of stock.

The limiting words "by means of a prospectus or oral communication" in Section 12(2), particularly in comparison to the significantly broader language of Section 17, shows clearly that the former had more limited scope than the latter. Had the 73rd Congress wished Section 12(2) to be coextensive with Section 17 in reaching all transactions, it would have simply stated that any misrepresentations "by means of any communication" in connection with the sale of a security would give rise to a Section 12(2) claim. Or, as it did in Section 17, it could have said "any person who offers or sells a security . . . by means of a misleading statement" shall be liable. The compelling inference is that Congress did not do so because Section 12(2) was not intended to be applicable to sales outside the public offering context.

III. THE PURPOSE OF THE 1933 ACT AND RELEVANT LEGISLATIVE HISTORY DEMONSTRATE THAT SECTION 12(2) APPLIES TO PUBLIC – NOT PRIVATE – SALES OF STOCK

A. The 1933 Act Was Intended To Require Full Dissemination Of Essential Information By Persons Soliciting The Public To Buy Securities

As explained in *Landis, supra*, at 36, the "patent concern" of the Act's draftsmen was "the flow of securities

from the issuer through underwriters **to the public** rather than with the subsequent buying and selling of these securities by the public"; *see also* L. Loss, *Fundamentals of Securities Regulation* at 92 (1983) ("The primary purpose of the 1933 Act was the regulation of the **distribution** of securities. Post-distribution trading is regulated by the 1934 Act.") (emphasis added). As stated in Abrams, *The Scope of Liability Under Section 12 of the Securities Act of 1933: "Participation" and The Permanent Legislative Materials*, 15 Fordham Urb. L.J. 877, 906 (1987), "Lawmakers in 1933 knew that the securities bill primarily regulating **distribution** would be followed swiftly by one primarily regulating trading. . . ." (emphasis added).

The bills that ultimately became the 1933 Act were S. Bill 875 and H.R. 5480. The evils toward which S. Bill 875 was directed were succinctly stated in the Senate Report accompanying that Bill:

> The purpose of this bill is to **protect the investing public and honest business**. The basic policy is that of informing the investor of the facts concerning securities to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresentation.
>
> The aim is to prevent further exploitation **of the public** by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities **offered to the public** through crooked promotion; to restore the confidence of the prospective investor in his ability to select sound securities;

> to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power.
>
> It is the conviction of the committee that these aims may be largely achieved upon the basis of fidelity to truth. Confidence must and may be restored upon the enduring basis of **honesty with the public**.
>
> The necessity for the bill arises out of the fact that billions of dollars have been invested in practically worthless securities, both foreign and domestic, including those of foreign governments, **by the American public** through incomplete, careless or false representations. The result is a dire national distress. In the protection **of the public** in its purchase of securities, the United States lags far behind other nations.

Senate Report at 1-2. As stated by Sen. Fletcher:

> Acting under [the commerce clause and the postal provisions] of the Constitution, we have undertaken to impose certain restrictions and to provide certain regulations in reference to securities **that are being offered to the public** throughout the country from time to time.
>
> We have no federal legislation covering this situation, and so, **in order to protect the public and in order to protect investors, this bill has been devised**.

77 Cong. Rec. 2983 (1933) (emphasis added). *See also* House Report at 2-3.[13]

In its General Analysis of the Bill, the House Report stated:

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[13] In addressing the legislative history, the Court in *Pacific Dunlop*, placed importance on the absence in the Senate Report of any statement similar to that in the House Report indicating that the "sale" referred to initial offerings:

> Although the legislative history in the House report can be read to focus solely on those offerings pursuant to a registration statement and prospectus (or in the Third Circuit's words, to initial offerings), the Senate's version of the 1933 Act and the conference report do not confirm the House's comments.

Pacific Dunlop, 993 F.2d at 592. This misses or ignores the fact that S. Bill 875 had an isolated transaction exemption (in essence exempting private transactions) which made clear the Senate's fundamental agreement with the House that the Act would be directed only toward abuses in the context of distributions of securities to the public. Plainly, the Senate Bill did not conflict with the House's comments. In any event, as acknowledged by the Seventh Circuit, "[t]he Senate rarely mentioned the word 'prospectus' and certainly not in the fraud (sic) context of Section 12(2). And the Senate, as compared to the House, did not draft as detailed a report in support of the bill." *Id.* at 591. Nonetheless, the court relied on silence by the Senate to negate the House Report statement that Section 11 and 12 liabilities attach only to untrue statements "in the registration statement or the prospectus – **the basic information by which the public is solicited**." House Report at 9. The Conference Committee Report, H.R. Rep. No. 152, 73d Cong., 1st Sess. (1933) (the "Conference Committee Report"), indicates that the Committee did not view Section 12(2) as applicable to a private resale, observing only that "A point of difference between the House bill and the Senate amendment concerned the civil liability of persons responsible for the **flotation of an issue**" which signals agreement of the House and Senate that liability was limited to such a context. Conference Report at 26-27.

> The bill affects only new **offerings** sold through the use of the mails or of instrumentalities of interstate or foreign transportation or communication. It does not affect the ordinary redistribution of securities **unless such redistribution takes on the characteristics of a new offering** by reason of the control of the issuer possessed by those responsible for the **offering**.

House Report at 5 (emphasis added).[14]

The foregoing demonstrates conclusively that in adopting the 1933 Act the 73rd Congress intended that the Act apply to offerings of securities to the public, not privately negotiated transactions.

B. The 1933 Act Was Intended To Intrude No Further Than Necessary Into Business Affairs

Implementing the intent of Congress to interfere as little as possible with private business, S. Bill 875 and H.R. 5480 both included provisions exempting transactions not having the essential characteristics of a public offering. Section 12(c) of S. Bill 875 exempted from the bill:

> Isolated transactions in which any security issued subsequent to the date of approval of this Act is sold, or offered for sale, subscription, or delivery by the owner thereof, or by his representative solely for the owner's account, such sale or offer for sale, subscription, or delivery not being made in the course of repeated and successive transactions of a like character by such owner for the purpose of engaging in the purchase and sale of securities as a business, such owner or representative not being the issuer or underwriter of, or selling agent for, such security.

[14] Under the 1933 Act, the term "distribution" is generally treated as synonymous with the term "public offering." Section 2(11) of the Act assumes this to be the case. 15 U.S.C. § 77b(11). *See also Gilligan, Will & Co. v. S.E.C.*, 267 F.2d 461, 466 (CA2 1959), *cert. denied*, 361 U.S. 896 (1959); *Cheltenham Bank v. Drexel Burnham Lambert, Inc.*, 1989 Fed. Sec. L. Rep. ¶ 94,391 (E.D.N.C. 1989); *Neuwirth Investment Fund, Ltd. v. Swanton*, 422 F. Supp. 1187 (S.D.N.Y. 1975).

The exemption of transactions "not involving any public offering" by Section 4 of H. R. 5480 (and ultimately incorporated in the 1933 Act) demonstrates even more clearly that the disclosure and private remedy provisions of the 1933 Act were limited to public offerings. Discussing this exemption, the House Report stated: "In view of these exemptions and the restriction of the bill's application to new offerings, **the bill does not affect transactions beyond the need of public protection** in order to prevent recurrences of demonstrated abuses." *Id.* at 7 (emphasis added).

In discussing when stockholders might become underwriters, thus losing the Section 4 exemption, the House Report stated:

> At some future date [the stockholders] may wish to dispose of their holdings and to **make an offer of this stock to the public**. Such a public offering may possess all of the dangers attendant upon a new offering of securities. Whenever such a redistribution reaches significant proportions, the distributor would be in the position of controlling the issuer and thus able to furnish the information demanded by the bill.

> This being so, the distributor is treated as equivalent to the original issuer and, **if he seeks to dispose of the issue through a public offering he becomes subject to the Act.**

Id. at 13-14 (emphasis added).

In sum, the exemptions in the respective bills, and the Reports and other relevant legislative history, repeatedly demonstrate the 73rd Congress' judgment that there was not sufficient public benefit to require **all** sellers of stock to comply with the stringent duties imposed on sellers engaging in public offerings. Rather, they confirm Congress' fulfillment of its commitment to limit the 1933 Act to regulating offerings of securities to the public while interfering as little as possible with private business transactions like that at issue in this case.

IV. IT WOULD BE POOR PUBLIC POLICY TO APPLY THE SECTION 12(2) REMEDY TO PRIVATE SALES OF STOCK

This Court has acknowledged that, in construing terms in the federal securities acts, it is proper to consider the policy considerations involved. *See Pinter*, 486 U.S. at 653; *Landreth*, 471 U.S. at 694-95 n.7 (1985). In particular, policy considerations can be considered when they help to show that adherence to text or structure would lead to a result so "bizarre" that Congress could not have intended it. *Demarest v. Manspeaker*, 498 U.S. at 191 (1991). Those policy considerations all militate against extension of Section 12(2)'s remedy to privately negotiated transactions.

The extension of Section 12(2) and its stricter standards of liability to private transactions currently governed by Section 10(b) of the 1934 Act would afford all buyers, and only buyers, a remedy which effectively renders superfluous Rule 10b-5 and years of precedent with respect to scienter, reliance, and loss causation under that Rule. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 306; *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (CA3 1981), *cert. denied*, 455 U.S. 938 (1982); *Basic v. Levinson*, 485 U.S. 224 (1988); *Central Bank of Denver v. First Interstate Bank of Denver*, No. 92-485, 1994 WL 132212 (U.S. April 19, 1994).

In privately negotiated transactions, contract remedies and the stricter standards of proof governing a Rule 10b-5 action, equally available to sellers and buyers, are far more appropriate than the standards governing a Section 12(2) action. There is no imbalance in the availability of information as between sellers and buyers and each of them is able to fend for itself, negotiate its rights and avail itself of the remedies afforded under the law of its contracts as supplemented by Rule 10b-5.

A broad construction of the scope of Section 12(2) here would have a drastic impact on the thousands of private transactions negotiated and closed yearly. This simply cannot be squared with the declarations, discussed above, of the President and the 73rd Congress to intrude as little as possible in business affairs. At a minimum, such a broad application of Section 12(2) would dramatically and unnecessarily increase transaction costs by forcing unnecessary due diligence onto sellers and their professionals to avoid unintentional misrepresentation. It would appear that the only way that a seller could assure itself of avoiding a possible "omission" within the

meaning of Section 12(2) would be to disclose all the information required in a registration statement to a buyer, even where a sophisticated buyer is expressly willing to assume a risk relating to a decision not to conduct an investigation. *See generally* Weiss, *supra*, at 32. ("Sophisticated parties negotiating at arm's length should be allowed to agree to so allocate the burden of investigation. If the law requires a seller to bear that burden even though the parties prefer to assign it differently, transaction costs will increase unnecessarily."); Fishman, *Duty to Disclose under Rule 10b-5 in Face-to-Face Transactions*, 12 J. Corp. L. 251 (1987) ("[O]ne of the underlying themes in these types of transactions is that the parties are in a position to obtain the protections and disclosure that they desire – that is, representations and warranties are obtained by a purchaser concerning only the matters in which it is interested"). Only if clearly mandated by the 1933 Act should it be applied to interfere so directly with the parties' freedom to reach such agreements – in a private setting – as they deem appropriate.

As in this case, interim financial statements nearly always include estimated components. While sellers may well be willing to represent the accuracy of the estimates if their exposure is limited to a buyer's damage in the event the estimate is erroneous, Section 12(2) applicability would nearly always force them to conduct an audit rather than risk giving the buyer an option to rescind the transaction. Further, because the provisions of the securities laws cannot be waived, 15 U.S.C. § 77o, such a construction would appear to render unenforceable the "baskets" which are frequently included in stock

purchase agreements quantifying the level of damages necessary to create a right to relief under the negotiated agreement.

Moreover, the broad construction Buyers seek would turn cases which are properly state breach of contract cases (based on the representations in the contract) into federal cases which shift the burden of proof onto the defendant, impose a negligence standard of liability and allow the unique rescission remedy. This also will obviously increase the already overburdened federal court system.

Finally, the powerful and positive remedy of Section 12(2) applied so expansively would certainly provide an irresistible temptation to any buyer who is disappointed for any reason with its purchase to attempt to concoct a claimed misrepresentation given the burden of proof that Section 12(2) imposes on a seller.

Extending the remedy of Section 12(2) to privately negotiated transactions would interfere totally and unnecessarily with the ability of private parties to set the limits of their bargains and undertakings and dramatically increase the cost of such transactions and increase litigation, often frivolous federal court litigation. Petitioners respectfully submit that the Court should not apply Section 12(2) so broadly given the negative impact on the public interest of such an expanded application.

CONCLUSION

The language of Section 12(2), the purpose and structure of the 1933 Act, the legislative history of the Act and Section 12(2) and the interplay between the 1933 Act and the 1934 Act all demonstrate that Section 12(2) was not intended to apply to privately negotiated sales of stock.

The District Court correctly concluded that Section 12(2) does not apply to this privately negotiated sale of the stock of Alloyd to Buyers and its summary judgment in Sellers' favor should be reinstated and affirmed.

Respectfully submitted,

Arthur L. Gustafson

By:
Donald W. Jenkins*
Thomas P. Desmond
Jennifer R. Evans

Vedder, Price, Kaufman & Kammholz
222 North LaSalle Street
Suite 2600
Chicago, Illinois 60601
312/609-7500

*Counsel of Record

Daniel R. McLean and Francis I. Butler

By:
Harold C. Wheeler*
Peter C. Woodford
Debra A. Winiarski

Seyfarth, Shaw, Fairweather & Geraldson
55 East Monroe Street
Chicago, Illinois 60603
312/346-8000

*Counsel of Record

No. 93-404

In The

Supreme Court of the United States

October Term, 1993

ARTHUR L. GUSTAFSON, DANIEL R. McLEAN and FRANCIS I. BUTLER,

Petitioners,

v.

ALLOYD CO., INC. and WIND POINT PARTNERS II, L.P.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

BRIEF OF RESPONDENTS

STATEMENT OF THE CASE

This case involves the sale of substantially all of the stock of Alloyd Co., Inc. by the three shareholders who owned and controlled the company. They solicited buyers, and ultimately sold their stock to an affiliate of respondent Wind Point Partners, II, L.P. ("Wind Point"). The sellers of Alloyd's stock, who are the petitioners in this case, made numerous written and oral representations about Alloyd to induce Wind Point's purchase of their shares. Respondents eventually discovered that some of these representations were untrue and sued for rescission under section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77l(2).

The Transaction At Issue

Alloyd Co., Inc. was founded in 1961 by petitioner Arthur Gustafson. (R. 56, Dep. Ex. 2 at 1)[1] Prior to the transaction at issue in this case, all of Alloyd's stock was owned by Gustafson and the other two petitioners – Daniel McLean and Francis Butler. Gustafson (Alloyd's president) owned 85 percent, McLean (chief financial and operating officer) owned 10 percent, and Butler (vice president for marketing and sales) owned 5 percent.[2] (R. 56, Dep. Ex. 5 at 19) There is no evidence in the record that shares of Alloyd's stock were ever sold or distributed to any person before the sale to Wind Point.

In May 1989, Gustafson, McLean and Butler decided to sell their Alloyd stock. (R. 56, Dep. Ex. 3 at 1) A proposal was made to the Alloyd board that "the Company actively solicit bids for the purchase of all of the outstanding stock of the Company." (*Id.*) In a Written Consent Of Directors dated May 5, 1989, Alloyd's directors authorized Gustafson "to engage KPMG Peat Marwick on behalf of the Company and its shareholders in the solicitation and evaluation of offers to purchase the Company." (*Id.*)

Peat Marwick prepared a detailed "Profile" of Alloyd to use as a selling tool with prospective buyers. (R. 56, Dep. Exs. 2 and 5; McLean Dep. 132) The Profile described Alloyd's operating, financial, marketing and other characteristics. (R. 56, Dep. Ex. 5) The Profile also stated that Alloyd's shareholders would be available to furnish additional information to prospective purchasers. (*Id.* at G0001428)

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[1] Record citations are to the docket entries in the District Court. Docket entries containing multiple tabs or pages are cited to a specific tab and/or page. For example, the citation "R. 56, Dep. Ex. 2 at 1" refers to docket entry number 56 (Appendix of Exhibits and Deposition Excerpts in Support of Plaintiffs' Motion for Summary Judgment), Deposition Exhibit No. 2 within the Appendix, at page 1. Citations to the Joint Appendix are designated by the prefix "J.A."

[2] Petitioners are referred to collectively as "Sellers."

In July 1989, Peat Marwick contacted Wind Point to see if Wind Point had any interest in purchasing Alloyd's stock and subsequently provided a copy of the Profile to Wind Point. (R. 56, Kracum Dep. 43-44, 48) Based on the information in the Profile, Wind Point submitted a written proposal to purchase the stock. (*Id.* at 55-56, Dep. Ex. 12) Sellers accepted Wind Point's bid, which was one of several received from prospective purchasers. (R. 56, Gustafson Dep. 72-73)

On October 17, 1989, Sellers and Wind Point executed a Letter Agreement setting forth the economic terms of Wind Point's proposed purchase of Sellers' stock.[3] (R. 56, Dep. Ex. 13) Under the terms of the Letter Agreement, Buyers were to pay Sellers approximately $38 million in total consideration (including notes, covenants, assumption of debt and an equity interest that McLean and Butler would retain in the new corporation). (*Id.*) Wind Point calculated the purchase price based on a multiple of 7.5 times Alloyd's earnings before interest and taxes (EBIT), determined by annualizing the interim financial figures provided by Sellers. (R. 56, Kracum Dep. 112, 115-16)

Both before and after signing the Letter Agreement, Wind Point attempted to learn as much as it could about Alloyd's business and financial condition. (*Id.* at 92-93, 95) McLean, acting as Sellers' spokesman on financial issues, provided Wind Point with interim operating results and annualized numbers for the entire year 1989 based on those interim numbers. (R. 56, Gustafson Dep. 30; McLean Dep. 197, 206-09; Kinney Dep. 183; Blank Dep. 23). These numbers reflected McLean's estimate of Alloyd's manufacturing costs based on his knowledge of the company's historical costs and day-to-day operating experience. (R. 56, McLean Dep. 51-52)

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[3] The Letter Agreement specified that Wind Point would form a new corporation to purchase substantially all of the outstanding common stock of Alloyd. The new corporation established by Wind Point was incorporated in Delaware and named Alloyd Holdings, Inc. Collectively, respondents Wind Point and Holdings, which has been renamed Alloyd Co., Inc., are referred to as "Buyers."

Mclean also had discussions with Wind Point representatives during which he made numerous oral representations concerning Alloyd's financial condition. For example, McLean told Wind Point that: (1) any year-end adjustments to inventory would not be significant (R. 61, Argall Dep. 48); (2) no material adjustments to Alloyd's financial statements would occur at year end in 1989 (R. 61, Blank Dep. 25; Argall Dep. 45-46); (3) his gross profit margins were conservative and, if anything, understated Alloyd's income (R. 61, McLean Dep. 147, 230; Wallace Dep. 74-75); and (4) he expected Alloyd's annualized 1989 operating profit to be $4.85 million. (R. 56, Blank Dep. 68-71, 82)

On December 20, 1989, the parties executed a Stock Purchase Agreement, along with accompanying disclosure schedules and other ancillary documents. (J.A. 87) At that time, Sellers provided Buyers with Consolidated Interim Financial Statements for the ten months ended October 31, 1989, which are referred to in the Purchase Agreement as the "Latest Balance Sheet." (J.A. 115, 164-70)

Article IV of the Stock Purchase Agreement contains a series of representations and warranties made by Sellers "[a]s an inducement to Buyer to enter into this Agreement." (J.A. 111) Among other things, Sellers represented that:

(1) the financial statements provided to Holdings, including the Latest Balance Sheet, "present fairly on a consolidated basis the Company's financial condition and related results of operations as of the times and for the periods referred to therein" (J.A. 115 at ¶ 4D);

(2) between the date of the Latest Balance Sheet and the date of the Stock Purchase Agreement, there were no material adverse changes in "the business, financial condition, operating results, assets, operations or business prospects" of Alloyd (J.A. 117 at ¶ 4I); and

(3) Sellers had not failed to disclose any material facts that would adversely affect Alloyd's "business, financial condition, operating

results, assets, operations or business prospects" (J.A. 140 at ¶ 4Z).

At the closing on December 22, 1989, Sellers reaffirmed that all of their representations continued to be true and correct. (R. 56, Dep. Ex. 10)

Less than two months after the closing, Buyers discovered a significant inventory shortage in the course of the 1989 year-end audit of Alloyd. (R. 56, Kracum Dep. 263-66) McLean testified he was "shocked" by the disparity between the book and actual inventory figures. (R. 56, McLean Dep. 356-57) Gustafson testified he was troubled when he learned of the variance because "the material should have been there, or somebody played with the books somehow." (R. 56, Gustafson Dep. 107-08) As a result of this inventory discrepancy, it was apparent that Alloyd's profit margin and operating income were materially lower than Buyers were led to believe based on the Latest Balance Sheet.

On April 3, 1990, Peat Marwick issued its audited financial statements of Alloyd for the year ending December 31, 1989. (R. 56, Dep. Ex. 19) The audited balance sheet showed that Alloyd had $1.2 million less in inventory than shown on the Latest Balance Sheet provided to Buyers. (*Compare* R. 56, Dep. Ex. 19 *with* J.A. 164-70) That inventory shortfall had a significant impact on Alloyd's bottom line. EBIT, the number on which Wind Point had based its multiple-of-earnings purchase price, was nearly $1.5 million (roughly 35%) less than the figure derived from the financial data in the Latest Balance Sheet (and orally confirmed by McLean). (*Id.*)

As a result of Sellers' overstatement of Alloyd's inventory and operating income, Buyers paid substantially more for Alloyd's stock than they would have paid if the Latest Balance Sheet and other financial records of the company had fairly presented its 1989 results of operations and income. On February 11, 1991, Buyers sued Sellers in the United States District Court for the Northern District of Illinois. (R. 1) Buyers asserted two claims: (1) violation of Section 12(2) of

the Securities Act of 1933, 15 U.S.C. § 77l(2);[4] and (2) breach of the representations and warranties in the Stock Purchase Agreement. (*Id.*)

Opinions Below

After extensive discovery, the parties filed cross-motions for summary judgment. On May 29, 1992, the district court entered an unpublished Memorandum Opinion and Order granting Sellers' motion, ruling that section 12(2) does not apply to the transaction between the parties.[5] (J.A. 10) The district court relied on the Third Circuit's holding in *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682 (3d Cir.), *cert. denied*, 112 S. Ct. 79 (1991), that "Section 12(2) only applies to initial offerings and not to after-market trading." (J.A. 20)

Buyers appealed the judgment of the district court to the Seventh Circuit Court of Appeals. In an unpublished Order, the Seventh Circuit vacated the May 29, 1992 Order and remanded the case for further proceedings in light of its ruling in *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578 (7th Cir. 1993), *cert. granted*, 114 S. Ct. 907, *cert. dismissed*, 114 S. Ct. 1146 (1994).

In *Pacific Dunlop*, the Seventh Circuit held that section 12(2) applies to "any communication which offers any security for sale or confirms the sale of any security," including a stock purchase agreement. 993 F.2d at 595. (J.A. 80) In reaching this conclusion, the court focused on whether a sale of stock pursuant to a privately negotiated stock purchase agreement constituted a sale "by means of a prospectus or oral communication" and whether Congress intended section 12(2) to apply to such a transaction. *Id.* at 582. (J.A. 47-48)

[4] The Securities Act of 1933 is referred to in this brief as the "1933 Act" or the "Act."

[5] The court denied Sellers' motion on two other grounds and declined to address the remaining grounds asserted in support of Sellers' motion. (J.A. 13-19) The court dismissed Buyers' pendent state-law breach of contract claim for lack of subject matter jurisdiction and denied Buyers' motion as moot. (J.A. 21-22)

The Seventh Circuit began by analyzing the text of the statute. Noting that the term "prospectus," like the other key terms used in section 12(2), is defined "very broadly," the court concluded that a prospectus includes "a contract of sale or any other kind of written communication that disposes of a security." *Id.* at 582-83. The court found that the contract at issue in that case was a "prospectus" because it contained factual representations that formed the basis of the lawsuit. *Id.* at 583.

The court concluded that neither the context of section 12 nor the broader context of the 1933 Act as a whole required a definition of "prospectus" narrower than the broad definition in section 2(10). *Id.* at 584-88. The court also concluded that "[t]he legislative history of the 1933 Act does not require the context of the word 'prospectus' to have a more narrow definition [in section 12(2)] than that specified in section 2(10)." *Id.* at 592. Finally, the court held that nothing in the remedial structure of section 17(a) of the 1933 Act or section 10(b) of the 1934 Act required a different interpretation of section 12(2). *Id.* at 594.

Sellers filed a petition for *certiorari* from the judgment of the Seventh Circuit vacating and remanding the case to the district court. This Court granted Sellers' petition on March 7, 1994.

Subsequent Proceedings

Following remand from the Seventh Circuit, and shortly before filing their petition for *certiorari*, Sellers again moved for summary judgment on Buyers' section 12(2) claim. (R. 86-88) Sellers' motion asserted, among other things, that there was no evidence Sellers had made any material misrepresentations of fact. (R. 86 at 6-11) On March 24, 1994 the magistrate judge to whom the motion was referred entered a Report and Recommendation on the motion concluding that Sellers' motion should be denied. (R. 102)

The magistrate judge found the evidence raised an inference that Sellers had attempted to reassure Buyers that the interim financial figures were conservative and reliable. (R. 102 at 17) The Report and Recommendation summarized this evidence as follows:

> There is evidence that McLean responded to KPMG's concerns regarding the use of estimated inventory figures, by convincing plaintiffs and the KPMG representatives that a physical audit would be unnecessary and not cost effective. According to several people associated with both Wind Point or KPMG, McLean told them that his figures in the Latest Balance Sheet were conservative estimates and that any adjustments were more likely to be positive, than negative.

(*Id.*) The Report also concluded there was "evidence suggesting that [Sellers] performed no investigation, nor did they ask anyone else to perform one, as to whether the Latest Balance Sheet was fairly representative of Old Alloyd's financial condition." (*Id.* at 20)

With respect to the Stock Purchase Agreement, the Report stated that, "[f]ar from being a cautionary statement regarding Old Alloyd's financial condition on October 31, 1989, one could reasonably infer from the Agreement that defendants were confident that the Latest Balance Sheet was reliable." (*Id.* at 17) Thus, the magistrate judge concluded that "a reasonable juror could find that [Sellers] represented that the figures were free of material errors." (*Id.* at 22-23)

The magistrate judge also rejected Sellers' argument that Buyers were made whole by Sellers' $815,000 payment pursuant to the purchase price adjustment provision in the Stock Purchase Agreement. (*Id.* at 30) The magistrate judge concluded that the purchase price adjustment did not adequately compensate Buyers because they had paid a multiple of Alloyd's earnings and therefore "should also be entitled to recover any difference that would have made in the portion of the purchase price that was based on a multiple of those earnings." (*Id.* at 31)

SUMMARY OF ARGUMENT

Section 12(2) of the 1933 Act is a carefully worded provision that creates an expansive civil remedy for misrepresentations made by sellers of securities. It provides that any person who sells or offers to sell a security "by means of a written prospectus or oral communication" that contains materially misleading statements is liable to the purchaser of the security. The operative terms used by Congress in section 12(2) are defined broadly in the Act or, where not defined, have an expansive common meaning. Neither the text of section 12(2) nor any other provision of the 1933 Act expressly exempts privately negotiated sales of securities from the civil remedy provided to purchasers, or limits section 12(2) to public offerings.

Congress' use of the word "prospectus" in section 12(2) does not limit the scope of transactions to which that section applies. In defining "prospectus," Congress eschewed the somewhat narrower common meaning of the word and defined it expansively as a term of art – just as it did with the other defined terms in the Act. It is inconsistent with both the statutory definition and the drafting style of the Act as a whole to conclude, as Sellers argue, that Congress used the word "prospectus" as an indirect way of limiting section 12(2) to public offerings and excluding private transactions from the civil remedies of the Act.

A straightforward reading of section 12(2) as encompassing both public and private transactions not only comports with the text, but is confirmed by the structure of the 1933 Act as a whole. When Congress intended to exempt specific categories of securities or transactions from the Act, it did so explicitly, as in section 3 (exempt securities) and section 4 (exempt transactions). That Congress did not expressly provide an exemption from section 12(2) for privately negotiated transactions is strong evidence Congress did not intend such an exemption. Moreover, it is inconsistent with the operation of the civil remedies provided in the Act to construe section 12(2) as creating a remedy for some, but not all, purchasers of

securities sold through materially misleading statements by sellers.

Applying section 12(2) to privately negotiated sales of securities is fully consistent with the broad remedial purpose of full *and* fair disclosure the Act was designed to ensure. The registration requirement of the Act focuses on providing information to investors who need it, while the civil remedy provisions address the truthfulness of representations made by sellers. Private offerings of securities are exempted from the registration requirements because parties to such transactions are deemed capable of obtaining the kind of information required in a registration statement. Having *access* to information, however, does not guarantee that the information obtained is *truthful.* The Act therefore does not draw distinctions between "public" and "private" purchasers when providing remedies for false or misleading statements of material fact.

In accord with the text of section 12(2) and the structure of the 1933 Act, the appellate courts for fifty years have consistently upheld section 12(2) claims arising out of privately negotiated sales of securities. Since shortly after passage of the Act, the SEC has similarly construed section 12(2) and the definition of "prospectus" in the Act broadly enough to provide a remedy for misrepresentations made in such transactions. Given this consistent construction by the courts of appeals and the agency responsible for administering the Act, the narrow construction of section 12(2) urged by Sellers would upset the justified expectations of the legal and investment communities.

Sellers rely on legislative history and policy arguments, neither of which provide a sufficient basis for a constricted reading of section 12(2). The legislative history is largely silent on the question presented in this case. Nothing in the sparse legislative history of section 12(2) expresses Congress' intent to exclude privately negotiated transactions from the ambit of that section. Nor do general statements of intent to protect the "investing public" or to regulate offerings of stock to "the public" justify reading into section 12(2) a limitation that Congress itself did not expressly create. Similarly,

Sellers' policy arguments cannot overcome the broad reading of section 12(2) consistent with the text, structure and remedial purpose of the Act.

Finally, *amicus* Securities Industry Association offers a different limitation, arguing that only issuers of securities are subject to section 12(2). Going far afield of the type of transaction at issue in this case, SIA asks the Court to decide whether securities firms can be held responsible for negligent misstatements in their research reports and similar communications with their customers. That issue was not raised below, is not before the Court, and need not be decided to resolve the question presented in this case.

ARGUMENT

I. The Language And Structure Of The Statute Demonstrate That Section 12(2) Applies To Private Offerings.

This case poses a narrow and specific question of statutory construction: "Whether Section 12(2) of the Securities Act of 1933 extends to a privately negotiated sale of stock."[6] (Pet. Br. i) Sellers focus the question even more precisely in their brief as "[w]hether a Section 12(2) remedy applies to privately negotiated transactions that Section 4 exempts from the registration requirements of Section 5 of the 1933 Act." (Pet. Br. 11) Both the text of section 12(2) and the structure of the 1933 Act as a whole refute Sellers' argument that the remedial provisions of section 12(2) are limited to misrepresentations made in public offerings of securities.

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[6] Although Buyers accept the substance of the question presented by Sellers, it would more accurately be framed as: "whether section 12(2) of the Securities Act of 1933 should be limited to public offerings of stock." As discussed below, section 12(2) has been construed consistently to apply to privately negotiated sales since shortly after passage of the Act. The construction urged by Sellers would impose a new limitation on the statute.

A. The Text Of The Statute Does Not Limit Section 12(2) To Public Offerings.

The analysis of this issue must start with the text of the statute itself. *See, e.g., Reves v. Ernst & Young*, 113 S. Ct. 1163, 1169 (1993); *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 685 (1985). The limitation Sellers ask this Court to impose on section 12(2), however, is not expressed in the text of the statute. This is the best evidence that Congress did not intend to exclude purchasers in private transactions from obtaining a remedy under section 12(2) for material misrepresentations by the seller. *See Pinter v. Dahl*, 486 U.S. 622, 653 (1988) ("ascertainment of congressional intent with respect to the scope of liability created by a particular section of the Securities Act must rest primarily on the language of that section").

1. The Language of Section 12(2) Encompasses Both Public and Private Sales of Securities.

The language of section 12(2) creates a broad remedy for purchasers of securities. Congress neither used the term "public" in defining the types of purchasers entitled to that remedy, nor expressly exempted "private" transactions from its application. Rather, section 12(2) provides a remedy against "[a]ny person" who "offers or sells a security . . . by means of a prospectus or oral communication" that includes a material misstatement or omission. 15 U.S.C. § 77l(2). Congress did not expressly limit application of the section to issuers of securities, the entities that generally make initial offerings of stock to the public.

The defined terms used by Congress in drafting section 12(2) similarly demonstrate that the civil remedy was intended to apply broadly. Section 2(3) of the Act defines "sell" expansively to include "every contract of sale or disposition

of a security or interest in a security, for value."[7] 15 U.S.C. § 77b(3). Similarly, the term "offer" is defined to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." *Id.* Section 2(10) provides that, "[u]nless the context otherwise requires," the term "prospectus" means "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security." 15 U.S.C. § 77b(10). Read together, these broadly defined terms reflect an intent to create a remedy for materially misleading statements in communications used to offer or sell securities.[8]

Congress' use of the undefined term "oral communication" in section 12(2) further demonstrates that the civil remedy created in that section is not limited to public offerings. In the absence of a statutory definition, this Court will construe a statutory term "in accordance with its ordinary or natural meaning." *FDIC v. Meyer*, 114 S. Ct. 996, 1001 (1994). The ordinary and natural meaning of "oral communication" is obviously broad enough to encompass

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[7] If, as Sellers contend, the 1933 Act was intended to reach only public offerings, not privately negotiated sales, it is unlikely Congress would have defined "sale" – one of the critical operative words in the statute – to include "*every*" transaction or contract that disposes of a security, rather than sales "to the public."

[8] This Court read such similarly all-inclusive language in section 17(a)(1) of the Act broadly in *United States v. Naftalin*, 441 U.S. 768 (1979). Rejecting an argument that section 17(a)(1) only prohibited fraud directed against investors, the Court held that the expansive terms used by Congress did not require "that the victim of the fraud be an investor – only that the fraud occur 'in' an offer or sale." *Id.* at 772. The Court has also relied on Congress' "expansive" definitions of related terms in a statutory provision as probative of whether a particular term should be construed broadly or narrowly. *See Pennsylvania Dep't of Public Welfare v. Davenport*, 495 U.S. 552, 558 (1990).

representations made in private transactions.[9] Other than messages broadcast over radio or television, which are expressly covered by the definition of "prospectus," *see* 15 U.S.C. § 77b(10), oral communications generally occur in limited-audience contexts such as face-to-face meetings or telephone conversations. Such communications are often the principal medium through which representations are made in privately negotiated transactions.

Nor did Congress limit section 12(2) to public offerings through section 4 of the Act, which exempts private transactions from the registration requirements of the Act. Section 4 provides in relevant part:

> The provisions *of section 77e* [section 5] of this title shall not apply to –
>
> (1) transactions by any person other than an issuer, underwriter, or dealer.
>
> (2) transactions by an issuer not involving any public offering.

15 U.S.C. § 77d(1)-(2) (emphasis added). Section 4 contains no reference to, much less any exemption from, the remedial provisions of section 12(2).

Thus, neither section 12(2) nor section 4 of the Act creates an express exemption from the civil remedies of section 12(2) for privately negotiated sales of securities. To the contrary, Congress drafted section 12(2) expansively to encompass misrepresentations made in the full array of communications used to sell securities, while carefully wording the private offering exemption in section 4 to apply only to

[9] The meaning of "oral communication" cannot be narrowly cabined through the doctrine of *ejusdem generis* – that general words following specific words in a statutory list will be construed as limited to objects similar in nature to those encompassed by the specific term. First, as discussed *infra*, the only other term that precedes "oral communication" in describing the communications covered by section 12(2), "prospectus," is itself defined expansively, not narrowly. Second, the Court has stated that the doctrine does not apply to terms "made separate and distinct from one another by Congress' use of the disjunctive." *Garcia v. United States*, 469 U.S. 70, 75 (1984). Here, "prospectus" and "oral communication" are used in the disjunctive.

the Act's registration requirement.[10] As stated by Professor Loss: "To start with what is clearest, the Section [12(2)] applies to all sales of securities, whether or not registered and whether or not the particular security or transaction is exempted from § 5 . . . ."[11] L. Loss & J. Seligman, *Securities Regulation* 4198 (3d ed. 1992); *see also* T. Hazen, *The Law of Securities Regulation* 305 (2d ed. 1990) (section 12(2) has no express limitation to "distributions" and thus "applies regardless of the context of the sale").

Reading section 12(2) as applicable to privately negotiated sales is consistent with the Court's decisions construing the 1933 Act. In *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 692 (1985), the Court held that the sale of all the stock of a corporation constituted a sale of a security within the scope of the 1933 and 1934 Acts. The Court rejected the argument that the Acts were not intended to cover "privately negotiated transactions involving the transfer of control to

[10] In attempting to overcome this reading of the text, Sellers assert that the phrase "by means of a prospectus or oral communication" in section 12(2) is superfluous unless read as limiting the section to "some, but not all, sales of securities." (Pet. Br. 21-22) From this dubious premise, Sellers leap to the erroneous conclusion that the phrase *must* limit section 12(2) to public offerings. Sellers' argument depends on the proposition that, absent the phrase "by means of a prospectus or oral communication," the language of section 12(2) would provide a remedy for misrepresentations in all sales of securities. But the syntax of section 12(2) does not support this proposition. To the contrary, deletion of the "by means of . . . " phrase makes section 12(2) meaningless, because without it there is no referent for the clause "which includes an untrue statement of material fact . . . . " The words "by means of a prospectus or oral communication" are the operative words that give section 12(2) meaning; they do not limit a broader meaning that it would have without them.

[11] The SEC has expressed precisely the same view of the relationship between the exemption for private transactions and the Act's civil remedies. In Rule 506 of Regulation D, 17 C.F.R. § 230.506, the SEC sets forth the criteria for compliance with the private offering exemption in section 4(2). The preliminary notes to Regulation D explain that the transactions exempted from registration under it "are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws."

'entrepreneurs'." In support of this conclusion, the Court noted that "although § 4(2) of the 1933 Act, 15 U.S.C. § 77d(2), exempts transactions not involving any public offering from the Act's registration provisions, there is no comparable exemption from the antifraud provisions." *Id.*

Sellers suggest that *Landreth* is inapposite because it dealt only with the question whether a privately negotiated sale of stock "involved the sale of a 'security' within the meaning of the 1934 Act." (Pet. Br. 11-12) Contrary to Sellers' argument, neither the Court's holding nor its reasoning in *Landreth* was limited to the 1934 Act. Rather, the Court expressly (and repeatedly) stated that the transaction in that case constituted a sale of a security within the meaning of the securities "Act*s*." 471 U.S. at 683, 687, 688, 692, 694, 697 (emphasis added).

The applicability of *Landreth* to the 1933 Act, and to section 12(2) in particular, is confirmed by *Gould v. Ruefenacht*, 471 U.S. 701 (1985), a decision Sellers' brief ignores. In *Gould*, the purchaser of a block of stock in a privately negotiated transaction sued the seller under sections 12(2) and 17(a) of the 1933 Act and under Rule 10b-5. The purchaser had relied on financial documents and oral representations by the seller, who owned all of the company's stock prior to the sale. *Id.* at 702-03. The question presented was "whether the sale of 50% of the stock of a company is a securities transaction subject to the antifraud provisions of the federal securities laws (the Acts)." *Id.* at 702. The Court held that both Acts, and hence the antifraud provisions of both, applied for the reasons stated in *Landreth*. *Id.* at 704.

Like *Landreth* and *Gould*, this case involves the sale of a business by its controlling stockholders. Sellers actively solicited purchasers for their stock and distributed a "Profile" describing the attributes of the company to potential buyers. In follow-up discussions with respondent Wind Point, Sellers made a series of oral representations about the company's business, in particular the stability of its margins, in order to seal the deal. Finally, as an inducement to Buyers to enter into a binding contract for their shares, Sellers made detailed written representations regarding the financial condition of the company. Despite their extensive due diligence, Buyers were unable to discover that a number of Sellers' oral and written representations were untrue until after the closing. This transaction comes squarely within the terms of section 12(2).

2. The Courts of Appeal Have Consistently Applied Section 12(2) to Private Transactions.

Sellers erroneously state that the courts of appeal "are in conflict on th[e] issue" in this case. (Pet. Br. 11) The appellate courts are *not* divided on the question whether the civil remedies in section 12(2) of the 1933 Act apply to "private" sales exempt from registration by section 4 of the Act. To the contrary, as the Seventh Circuit stated in *Pacific Dunlop*, "[t]he courts have consistently held that the section 4 exemptions do not apply to section 12(2)." 993 F.2d at 587. *Accord Metromedia Co. v. Fugazy*, 983 F.2d 350, 361 (2d Cir. 1992) (stating that section 12(2) has "consistently been applied to private as well as public offerings of securities"), *cert. denied*, 113 S. Ct. 2445 (1993).

The decisions expressly stating that section 12(2) applies to private transactions exempt under section 4 of the Act span nearly fifty years. *See, e.g., Haralson v. E.F. Hutton Group, Inc.*, 919 F.2d 1014, 1032 (5th Cir. 1990) (holding that application of section 12(2) is not limited to public offerings); *Nor-Tex Agencies, Inc. v. Jones*, 482 F.2d 1093, 1099 (5th Cir. 1973) (holding that section 4(2) does not exempt a private transaction from "the anti-fraud provisions of section 12(2)"), *cert. denied*, 415 U.S. 977 (1974); *Woodward v. Wright*, 266 F.2d 108, 111, 114-15 (10th Cir. 1959) (stating that section 12(2) provides a remedy for "misrepresentation in the sale of the securities generally, whether registered or exempt from the registration requirements under [section 4]"); *Moore v. Gorman*, 75 F. Supp. 453, 456 (S.D.N.Y. 1948) (holding that

section 4 "does not purport to, nor does it, confer any exemption from the civil liability imposed by section 12(2)").[12]

In these decisions, the courts have found the statutory language dispositive in concluding that transactions exempt under section 4 are nevertheless subject to section 12(2). For example, the Fifth Circuit explained: "By its express terms, the private offer exemption only exempts a transaction from the registration requirements of sections 5 and 12(1), and does not exempt a transaction from the anti-fraud provisions of sections 12(2) of the '33 act or Rule 10b-5 under the '34 act." *Nor-Tex Agencies*, 482 F.2d at 1099 (citations omitted). The appellate courts have also repeatedly upheld section 12(2) claims predicated on private oral conversations between sellers and purchasers. *See, e.g., Metromedia*, 983 F.2d at 361; *Currie v. Cayman Resources Corp.*, 835 F.2d 780, 783 (11th Cir. 1988); *Schillner v. H. Vaughan Clarke & Co.*, 134 F.2d 875, 876-77 (2d Cir. 1943).

Sellers do not cite any case holding that section 12(2) is inapplicable to private transactions exempt under section 4 of the Act. Instead, the decisions cited by Sellers (Pet. Br. 12-14) address a different issue: whether section 12(2) applies only to "initial" offerings of stock, as opposed to "secondary market trading." *See Ballay v. Legg Mason Wood Walker, Inc.*,

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[12] Other appellate court decisions have upheld section 12(2) claims arising out of a variety of private transactions without expressly deciding the question. *E.g., Wright v. National Warranty Co.*, 953 F.2d 256 (6th Cir. 1992) (sale of unregistered securities pursuant to private placement memorandum); *Acme Propane, Inc. v. Tenexco, Inc.*, 844 F.2d 1317 (7th Cir. 1988) (private placement of unregistered securities to "sophisticated, informed" investors); *Currie v. Cayman Resources Corp.*, 835 F.2d 780 (11th Cir. 1988) (private offering of limited partnership interests); *Adalman v. Baker, Watts & Co.*, 807 F.2d 359 (4th Cir. 1986) (private offering of limited partnership interests); *Austin v. Loftsgaarden*, 675 F.2d 168 (8th Cir. 1982) (private offering of limited partnership interests); *Schillner v. H. Vaughan Clarke & Co.*, 134 F.2d 875 (2d Cir. 1943) (face-to-face oral representations inducing investment in company); *Cady v. Murphy*, 113 F.2d 988 (1st Cir.) (privately negotiated sale of voting trust certificates), *cert. denied*, 311 U.S. 705 (1940).

925 F.2d 682, 687-88 (3d Cir.), *cert. denied*, 112 U.S. 79 (1991); *First Union Discount Brokerage Services, Inc. v. Milos*, 997 F.2d 835, 843 (11th Cir. 1993); *Gross v. Diversified Mortgage Investors*, 431 F. Supp. 1080, 1095 (S.D.N.Y. 1977), *aff'd mem.*, 636 F.2d 1201 (2d Cir. 1980). *Ballay* involved a claim against a brokerage firm based on misstatements in the firm's research reports on a publicly traded company. 925 F.2d at 686. *First Union* involved a claim against a discount broker for trading through a margin account. 997 F.2d at 840. None of these cases addressed claims against sellers of stock in private transactions exempt under section 4.

As the Seventh Circuit pointed out in *Pacific Dunlop*, "[t]he public/private and initial/secondary are two entirely different questions." 993 F.2d at 585-86 n.12. For example, an "initial offering" of stock can be either public – via a widely disseminated registered offering – or private – pursuant to a limited offering exempt under section 4(2) of the Act. Similarly, a "public" offering can be either an initial offering of stock by an issuer or a secondary offering by a large stockholder. In short, the two dichotomies define related, but different, categories of transactions.

The *Ballay* decision illustrates this difference. In *Ballay*, the court held that a brokerage firm's oral communications relating to "a *public market transaction*" were not within the scope of section 12(2). (Pet. Br. 13, emphasis added) The *Ballay* court focused exclusively on the distinction between initial and secondary offerings. The application of section 12(2) to a privately negotiated sale by controlling shareholders was never an issue in that case, and the court did not address the public/private distinction urged by Sellers here.

The prolonged period of time over which the appellate courts have consistently read section 12(2) as applicable to private transactions is itself a reason to affirm that construction. That these courts have found the statutory language clear enough to obviate any need for extensive analysis or resort to legislative history supports the conclusion that the text of the statute answers the question presented. *Cf. United States v. Naftalin*, 441 U.S. 768, 779 (1979) (Where Congress has

conveyed its purpose clearly, "we decline to manufacture ambiguity where none exists.") (citations omitted). Where the lower courts have been unanimous in a particular reading of a remedial provision, "such a settled construction of an important federal statute should not be disturbed unless and until Congress so decides." *Reves v. Ernst & Young*, 494 U.S. 56, 74 (1990) (Stevens, J., concurring).[13] At a minimum, the consistent application of section 12(2) to private transactions should place on Sellers the burden of demonstrating that the statute cannot reasonably be read the way courts have read it for fifty years.

B. The Use Of The Term "Prospectus" Does Not Limit Section 12(2) To Public Offerings.

Sellers attempt to fashion a textual argument based on one word in section 12(2) – "prospectus." They argue that what Congress failed to do directly, by explicitly limiting section 12(2) to public offerings, it did indirectly by using the term "prospectus" in section 12(2). It is simply too much to believe that Congress intended to impose such a significant limitation on the scope of the Act's civil remedy through the use of this one word.

Sellers contend that "prospectus" imposes a limitation on the types of *transactions* covered by section 12(2) – public offerings vs. private transactions. The phrase "by means of a prospectus or oral communication," however, addresses types of *communications*, not types of transactions. When Congress intended to exempt particular types of transactions, it did so explicitly, as in section 4. Similarly, when Congress intended to exempt particular types of securities, it did that explicitly

[13] Although a majority of the Court recently found this principle inapplicable in *Central Bank of Denver v. First Interstate Bank of Denver*, 114 S. Ct. 1439, 1452 (1994), that case did not present a similarly settled construction of an express statutory remedy. Rather, as the Court noted, numerous courts had questioned whether it was appropriate to append an implied cause of action for aiding and abetting to the implied right of action under Rule 10b-5. *Id.* at 1444.

too, as in section 3 of the Act. 15 U.S.C. § 77c. It is wholly inconsistent with this straightforward drafting style for Congress to have taken an indirect approach to limiting the transactions covered by section 12(2).

Furthermore, neither the dictionary definition of "prospectus" nor the use of that term in section 12(2) supports limiting section 12(2) to documents or oral statements in connection with public offerings of stock. As discussed above, section 2(10) of the Act defines "prospectus" broadly. If Congress had intended "prospectus" to have its common meaning, it need not have defined the word at all, just as it did not define "oral communication." Alternatively, Congress could have reiterated in section 2(10) what Sellers argue was the "well-established meaning" in 1933 and defined "prospectus" as "[a] document published by a company or corporation . . . setting forth the nature and objects of an issue of shares . . . and inviting the public to subscribe to the issue." *Black's Law Dictionary* 1451 (3d ed. 1933). Congress did neither.

Instead, Congress chose to define "prospectus" by beginning with the word itself, then adding other terms that can only be read to broaden its scope. The repetition of the word "prospectus" as one in a series of words defining the term evidences Congress' intent that "prospectus" as used in the Act was not limited to its common dictionary definition.

The maxim *noscitur a sociis* – that a word is known by the company it keeps – does not compel a constricted reading of "prospectus." That maxim counsels that words in a series should be construed to have related, not identical, meanings. *Cf. Reves*, 494 U.S. at 64 (explaining that the definition of one term in a definitional series does not control the meaning

of other terms in the series).[14] Here, if the various terms used in the definition of "prospectus" – such as "letter" or "communication" – are read as mere synonyms for the dictionary definition of "prospectus," they would be superfluous. These additional terms must be read as having different, but related, meanings that each add something to the dictionary definition. *See Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 862 (1984) (regulatory statute's "listing of overlapping, illustrative terms was intended to enlarge, rather than to confine" the scope of the statute).[15]

Sellers argue that the only characteristic the various terms in the definition of "prospectus" could possibly have in common is the connotation of a public offering. (Pet. Br. 20-21) Nothing in section 2(10) or section 12(2) compels this conclusion. An equally plausible principle of relatedness, and one more consistent with the structure and context of section 12(2), is that each term connotes a communication that conveys some information or makes some representation about the securities being offered for sale – whether to the public at large or to a single investor. *See Pacific Dunlop*,

[14] In *Reves*, this Court addressed whether a particular instrument constituted a "note" as used in the series of terms defining "security" in the securities acts. The Court rejected defendant's argument that the instrument in question failed to meet the *Howey* test for identifying an "investment contract," another of the terms used to define "security." The Court stressed that these two defining terms had different meanings. "To hold that a 'note' is not a 'security' unless it meets a test designed for an entirely different variety of instrument 'would make the Acts' enumeration of many types of instruments superfluous'." 494 U.S. at 64, quoting *Landreth*, 471 U.S. at 692.

[15] The Third Circuit in *Ballay* asserted that Congress "more simply could have drafted Section 12 to govern all written or oral communications." *Ballay*, 925 F.2d at 689. As Professor Loss has explained, "it probably would not have occurred to the draftsmen – indeed, they very likely would have recoiled from the idea if it had been suggested – to say *written offer* rather than *prospectus* in section 12(2) when they had just defined *prospectus* to mean exactly that. In short, section 12(2) must be read as if it said 'by means of a written or oral communication'." L. Loss, *Securities Act Section 12(2): A Rebuttal*, 48 Bus. Law. 47, 51 (1992).

993 F.2d at 588 (key to defining "prospectus" lies in "whether the substance of the words used" offers to sell or confirms the sale of a security).[16]

The construction given to the term "prospectus" by the SEC confirms the Seventh Circuit's reading of section 12(2). In a 1941 opinion, the general counsel of the SEC explained that the term "prospectus" as defined in section 2(10) of the Act "covers more than the kind of formal document which the layman ordinarily has in mind when he uses the term."

> Under the Act a "prospectus" includes every kind of written communication which attempts or offers to dispose of, or solicits an offer to buy, a security for value, *or which constitutes a contract of sale* or disposition of a security for value.

SEC Release No. 33-2623, 11 Fed. Reg. 10964 (July 25, 1941) (emphasis added). Thus, "prospectus" should be read to cover a wide variety of communications, including a contract of sale or any other document that effectuates the sale of a security.[17]

[16] *Amicus* Securities Industry Association ("SIA") attacks the Seventh Circuit's opinion in *Pacific Dunlop* as holding that "any document *connected with the sale of a security* qualifies as a 'prospectus'." (SIA Br. 8; emphasis added) This misstates the Seventh Circuit's holding. What the court actually held was that "section 12(2) applies to any communication which offers any security for sale or confirms the sale of any security," a significantly narrower holding. 993 F.2d at 595. (J.A. 80)

[17] The principal authority cited by Sellers, *Ballay*, suggests that the term "prospectus" as defined in section 2(10) is limited to the specific type of prospectus required by section 10 of the Act, 15 U.S.C. § 77j. 925 F.2d at 688-89. (*See* Pet. Br. 13) That ignores the plain language of section 2(10), which is broader than section 10. The SEC has noted the distinction between the broad meaning of "prospectus" in section 2(10) and the "formal prospectus" referred to in section 10 of the Act, which must accompany a registration statement. The 1941 opinion explains that a "formal prospectus" is a "prospectus that meets the requirements of section 10," while the term "prospectus" as used in section 2(10) includes any document that offers a security for sale or constitutes a contract for sale of a security. SEC Release No. 33-2623, 11 Fed. Reg. 10964 (July 25, 1941). There is nothing in the text of section 12(2) suggesting that Congress intended to limit "prospectus" to a "formal" section 10 prospectus.

This interpretation of a statutory term of art by the SEC, especially in light of its relatively close temporal proximity to enactment of the statute, should be given substantial weight. This Court has long recognized that "considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer." *Chevron*, 467 U.S. at 844; *accord National R.R. Passenger Corp. v. Boston & Maine Corp.*, 112 S. Ct. 1394, 1401 (1992) ("Judicial deference to reasonable interpretations by an agency of a statute that it administers is a dominant, well settled principle of federal law.").

In sum, the definition of the term "prospectus" makes clear that Congress did not intend to limit that term to its narrower common definition. Rather, section 2(10) defines the term to include a wide range of written communications used to sell securities. This expansive definition is consistent with its companion term, "oral communication," and with the other expansively defined terms used in section 12(2). There is nothing in the context of section 12(2) that requires "prospectus" to have a narrower meaning in that section in order to limit the Act's civil remedies to public offerings.

C. The Structure Of The 1933 Act Confirms That Private Offerings Are Not Exempt From Section 12(2).

In construing a statutory provision, it is appropriate to examine not only the particular clause in question and the specific section in which it resides, but also the context of the statute as a whole. *See, e.g., Coit Independence Joint Venture v. FSLIC*, 489 U.S. 561, 573-74 (1989). This is particularly true when construing the securities laws. *See SEC v. National Securities, Inc.*, 393 U.S. 453, 466 (1969). Here, the other provisions of the 1933 Act, and the way in which those provisions are interrelated, confirm that section 12(2) is not limited to "public" offerings of stock.

As Professor Loss has explained, the 1933 Act has just two important substantive provisions: section 5 and section 17. 9 L. Loss & J. Seligman, *Securities Regulation* 4219 (3d ed. 1992). Section 5 contains the basic requirement that all

securities sold in interstate commerce through "any prospectus or otherwise" must be registered. 15 U.S.C. § 77e. Section 17 proscribes fraud in connection with offers and sales of securities in interstate commerce. *Id.* § 77q.

Sections 11 and 12 of the Act provide civil remedies to purchasers of securities damaged by violations of these provisions. Section 11 provides that any person who purchases a registered security may sue to recover damages suffered as a result of any material omission or misstatement in the registration statement. The potential defendants under section 11 include the issuer, its directors, those who sign the registration statement, underwriters, and experts whose work is incorporated in the registration statement. 15 U.S.C. § 77k(a). Section 12(1) provides that any person who purchases unregistered securities offered or sold in violation of section 5 may sue the seller for rescission. *Id.* § 77l(1). Finally, section 12(2) provides that the purchaser of stock sold by means of a materially misleading prospectus or oral communication may sue the seller for rescission or rescissory damages. *Id.* § 77l(2).

Sections 3 and 4 of the Act set forth a series of exemptions from the registration requirement of section 5 and other provisions of the Act. Section 3 lists several categories of securities exempt from the Act. 15 U.S.C. § 77c. Sections 12(2) and 17, however, provide that the exemptions in section 3 do not apply to those antifraud provisions. *Id.* §§ 77l(2), 77q(c). Section 4 contains a narrower set of exemptions; it identifies certain transactions to which the registration requirements of section 5 do not apply, but does not provide an exemption from any other provision of the Act. *Id.* § 77d. Read together, sections 3, 4, and 12 demonstrate that when Congress meant to exempt a particular type of security or transaction from one or more provisions of the Act, it did so

explicitly.[18] This makes the absence of an express "private transaction" exclusion in section 12(2) all the more telling. *See Patterson v. Shumate*, 112 S. Ct. 2242, 2246 (1992).

Sellers argue that section 12(2) "cannot reasonably be construed as applicable to private transactions while the closely related Section 12(1) plainly applies only to public offerings." (Pet. Br. 29) This is a *non sequitur*. Section 12(1) has no application to the various sales of securities exempted from the Act's registration requirements by section 3, yet those sales are expressly made subject to section 12(2).[19] It is no less reasonable for section 12(2) to apply to private transactions exempted from registration under section 4, even though such transactions are not subject to section 12(1).

Moreover, the civil remedy created in section 11 for misrepresentations in registration statements is not limited to public offerings. Privately negotiated sales of stock can also be registered, and Section 11 draws no distinction between purchasers of registered shares in a public offering and purchasers of such shares in privately negotiated

[18] This point is confirmed by the language of section 13 of the Act, which sets forth the limitation periods for the private rights of action created in sections 11 and 12. Section 13 establishes a three-year period of repose as follows:

> In no event shall any such action be brought to enforce a liability created under section 77k [section 11] or 77l(1) [section 12(1)] of this title more than three years after the security was bona fide *offered to the public*, or under section 77l(2) [section 12(2)] of this title more than three years *after the sale*.

15 U.S.C. § 77m (emphasis added). This section illustrates that Congress knew how to specify public offerings when that was its intent.

[19] For example, by virtue of Regulation D promulgated under section 3(b), certain offerings of securities less than $5,000,000 are exempt from the Act's registration requirements, and thus from section 12(1). 17 C.F.R. § 230.505. Section 12(2), however, applies to offerings regardless of dollar amount because the section 3 exemptions do not apply to section 12(2).

deals.[20] It would be incongruous to construe the Act as providing a "private" buyer of registered shares a remedy under section 11 for the seller's misrepresentations, but providing the same buyer no remedy under section 12(2) for misrepresentations made by a seller of unregistered shares in a private transaction.

Nor do sellers gain anything from their comparison of section 12(2) to section 17 of the Act, which outlaws fraud "in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce." 15 U.S.C. § 77q. Sellers argue that because section 17 does not refer to sales "by means of a prospectus or oral communication," the inclusion of this phrase in section 12(2) demonstrates that section 12(2) "was not intended to be applicable to sales outside the public offering context." (Pet. Br. 32)

Once again, Sellers' argument is a *non sequitur* because section 17 has significantly broader coverage than section 12(2) even if section 12(2) is read to apply to private transactions. For example, section 17 makes it unlawful for a person to tout securities through false or misleading statements even if no one actually purchases the securities. Section 12(2), by contrast, provides a private remedy only to a person who actually purchased stock from the person making the misrepresentation. *See Pinter v. Dahl*, 486 U.S. 622, 644 (1988) (purchase requirement confines section 12 liability to situations in which sale has taken place). Similarly, section 17(a)(3) prohibits persons from engaging in "any transaction, practice, or course of business" that operates as a fraud on a purchaser of securities. 15 U.S.C. § 77q(a)(3). This provision reaches a broader range of conduct than section 12(2), which is limited to misrepresentations in written or oral communications used to sell securities to a purchaser.

[20] Even where a registration statement is not required, section 6 of the Act provides that "[a]ny securities may be registered." 15 U.S.C. § 77f. *See, e.g., Westinghouse Elec. Co. v. '21' Int'l Holdings, Inc.*, 821 F. Supp. 212 (S.D.N.Y. 1993) (privately negotiated exchange of assets for $115 million in registered Westinghouse shares).

Construing section 12(2) as limited to public offerings would create a significant gap in the remedial structure of the 1933 Act. The Act provides a series of remedies for buyers of stock sold in violation of the substantive proscriptions in sections 5 and 17. Section 11 provides *every* buyer of registered securities with a remedy for misrepresentations in a registration statement. Section 12(1) provides a remedy to *every* buyer of unregistered securities sold in violation of section 5. Under Sellers' construction of section 12(2), however, only *some* buyers of unregistered shares sold through material misrepresentations would have a remedy under the Act against the seller who made the misrepresentations.

Sellers assert that Congress must have intended this gap in the 1933 Act remedies because "the 1934 Act created broad fraud remedies for buyers (as well as sellers) in connection with private (as well as public) sales of stock." (Pet. Br. 32) This argument rests on a faulty premise. The private right of action under section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b), is a remedy implied by the courts, not expressly created by Congress.[21] *See Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 113 S. Ct. 2085, 2088 (1993). The legislative history of section 10(b) does not indicate that Congress even considered providing such a private right of action. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 729 (1975). Moreover, the SEC did not adopt Rule 10b-5, 17 C.F.R. § 240.10b-5, which eventually served as the impetus for the creation of the private right of action to enforce section 10(b), until 1942.

There is no reason to infer that Congress intended in 1933 to exclude buyers of securities in private transactions from the scope of section 12(2) because they were adequately protected by antifraud remedies under the 1934 Act. Congress could not know that courts would eventually infer such a private right of action from an SEC rule adopted eight years

[21] While Congress created express rights of action in the 1934 Act, *see* 15 U.S.C. §§ 78i, 78p, 78r, none of those would apply to the kind of transaction at issue in this case.

after the Act. *See Blue Chip Stamps*, 421 U.S. at 730. As stated by Professor Loss, "it is almost inconceivable that these two great statutes – which repeatedly have been treated as *in pari materia* – were meant to afford no civil remedy whatsoever to the great bulk of investors who do not participate in distributions." 9 L. Loss & J. Seligman, *Securities Regulation* 4220 (3d ed. 1992).

II. Application Of Section 12(2) To Private Transactions Is Consistent With The Remedial Purpose Of The Statute.

The construction of section 12(2) that follows from the text of the provision and the structure of the Act is also fully in accord with the remedial purpose of the Act. This Court has noted repeatedly that "Congress had 'broad remedial goals' in enacting the securities laws and providing civil remedies." *Pinter*, 486 U.S. at 653, quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 200 (1976). Section 12(2) serves the statute's broad remedial goals by "creat[ing] potential civil liability for a seller of securities in favor of the purchaser for misleading statements or omissions in connection with the transaction." *Ernst & Ernst*, 425 U.S. at 200 n.27.[22] Accordingly, section 12(2) should be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972), quoting *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963).

[22] Sellers argue that section 12(2) is not "simply another 'antifraud provision'," but rather a "unique" fiduciary duty remedy. (Pet. Br. 15-16) This Court has repeatedly described section 12(2) as an antifraud remedy. *See, e.g., Reves*, 494 U.S. at 80 (Rehnquist, C.J., dissenting) (referring to section 12(2) as one of "the 1933 Act's antifraud provisions"); *Randall v. Loftsgaarden*, 478 U.S. 647, 655 (1986) ("Section 12(2) specifies the conduct that gives rise to liability for prospectus fraud and expressly creates a private right of action in favor of the defrauded investor . . . . "). Furthermore, the Court has used the same "fiduciary duty" analogy in describing the right of action under section 10(b) of the 1934 Act, which Sellers concede applies to privately negotiated transactions. *See Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 11-12 (1971).

Sellers assert that Congress did not intend the 1933 Act to reach "privately negotiated transactions involving sophisticated parties able to fend for themselves." (Pet. Br. 24) In support of this assertion, they rely on Justice Stevens' dissent in *Landreth*, arguing that Congress only wanted to protect investors "who are not in a position to protect themselves from fraud by obtaining appropriate contractual warranties." (Pet. Br. 12, quoting 471 U.S. at 698 (Stevens, J., dissenting)) On the basis of this dissenting view, they ask the Court to conclude that section 12(2) was not intended to provide a remedy for misrepresentations in privately negotiated sales exempt under section 4(2). (*Id.*)

The Court rejected this same argument in *Landreth* and *Gould* when it held that privately negotiated resales of controlling blocks of stock come within the scope of the 1933 Act. 471 U.S. at 692; 471 U.S. at 704. Addressing the remedial purpose of the 1933 and 1934 Acts, the Court stated:

> Reading the securities laws to apply to the sale of stock at issue here comports with Congress' remedial purpose in enacting the legislation to protect investors by "compelling full and fair disclosure relative to the issuance of 'the many types of instruments that in our commercial world fall within the ordinary concept of a security'." *SEC v. W.J. Howey Co.*, 328 U.S. at 299 (quoting H.R. Rep. No. 85, 73d Cong., 1st Sess., 11 (1933)).

Landreth, 471 U.S. at 687. The Court expressly concluded that neither the language nor the legislative history supported the narrower view of the Acts' scope urged by Justice Stevens' dissent.[23] *Id.* at 694-95 n.7.

Sellers' rationale for excluding private transactions from section 12(2) is no more compelling than it was in *Landreth*

[23] This Court addressed a related argument in rejecting an *in pari dilecto* defense to claims under section 12(1) in *Pinter v. Dahl*, 486 U.S. 622 (1988). The court below had expressed the concern that failure to provide such a defense would give too great an advantage to "sophisticated investors." *Id.* at 637 n.13. Rejecting this concern, the Court explained that "[p]ermitting the sophisticated investor to recover also serves to protect the unknowing and innocent investor." *Id.*

and *Gould* as a basis for excluding such transactions from the 1933 Act as a whole. Their argument ignores the difference between the registration requirements and the remedial provisions of the Act. The former focus on getting information to investors who need it; the latter are concerned with the truthfulness of the information provided. Congress was clearly concerned with *both* when it enacted the statute. *See, e.g.*, Maynard, *Section 12(2) of the Securities Act of 1933: A Remedy for Fraudulent Postdistribution Trading?*, 20 Sec. Reg. L.J. 152, 165 (1992) (remedies in sections 11 and 12 were intended to "enforce the dual purpose of the 1933 Act: first, to assure compliance with the disclosure requirements of the Section 5 registration obligations, and second, to eliminate fraud").

It is equally clear, however, that Congress did not view the transactions covered by the two types of provisions as coextensive. *Landreth*, 471 U.S. at 692. This is illustrated by the exemption in section 3(b) of the Act, which authorizes the SEC to add additional classes of securities exempt under section 3 "if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering." 15 U.S.C. § 77c(b). Any such securities remain subject to an action for rescission under section 12(2), however. *Id.* § 77l(2). Thus, Congress expressly concluded that buyers of securities for whom the protection of the Act's registration requirement is unnecessary should still be protected by the civil remedies of section 12(2).[24]

[24] In support of their argument that section 12(2) applies only to misstatements or omissions in public offerings, Sellers cite the Court's statement in *Randall v. Loftsgaarden* that "Congress chose a rescissory remedy when it enacted § 12(2) in order to deter prospectus fraud and encourage full disclosure." 478 U.S. at 658. This citation is curious, since *Randall* did not involve a public offering of securities. In that case, the Court held that the successful plaintiff in a section 12(2) case was not required to reduce his rescissory award by the amount of tax benefits he received on his investment. *Id.* at 667. The section 12(2) claim in that case arose out of a private placement of limited partnership interests. *See Austin v. Loftsgaarden*, 675 F.2d 168, 173 (8th Cir. 1982).

The reasons for exempting sellers in privately negotiated transactions from the registration requirement do not support excluding such transactions from the antifraud provision of section 12(2). Simply because a purchaser in a private transaction may have the ability to obtain the kind of information that would otherwise be required in a registration statement does not mean that such a purchaser cannot be misled.[25] The courts have long recognized that "sophisticated investors, like all others, are entitled to the truth." *Stier v. Smith*, 473 F.2d 1205, 1207 (5th Cir. 1973). This principle, combined with the lack of any express intent to the contrary, has led the courts to conclude that "[s]ection 12(2) does not establish a graduated scale of duty depending upon the sophistication and access to information of the customer." *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1229 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981).[26]

The distinction between having access to information and having *truthful* information is demonstrated by the facts of this case. Sellers solicited respondents to buy their stock.

[25] The language of section 12(2) deals directly with the purchaser's ability to obtain information by expressly providing that the purchaser of securities only has a remedy under that section if it did not know of the untruth or omission on which its claim is based. Thus, if the buyer discovers the falsehood, it has no claim; if it does not, there is no reason to deny it a remedy.

[26] The concept of limiting the application of section 12(2) based on the sophistication of the purchaser is both unworkable and inconsistent with the operation of the Act's other remedial provisions. Sophisticated purchasers buy stock in public offerings, and unsophisticated purchasers buy securities in private offerings. For example, the fund manager of a large mutual fund (such as Peter Lynch of Magellan Fund fame) may purchase shares in an initial public offering based on his exhaustive and highly sophisticated analysis of the company's prospects. If the registration statement contains a material misrepresentation, the fund has a cause of action under section 11. If a wealthy investor who knows nothing about the oil and gas business buys a limited partnership in a privately offered oil and gas partnership, there is no sound basis in policy for denying him a remedy for misstatements of fact in the offering documents.

After striking a deal in principle with Sellers, Buyers conducted due diligence. In the course of this due diligence, Buyers raised questions about year-end adjustments to inventory and pressed petitioner McLean for an explanation. McLean, who was Sellers' spokesman on financial issues and in the best position to know, assured Buyers that his methods of estimation were conservative and that any year-end adjustments to inventory would be positive, not negative. Sellers reiterated this assurance by making express representations in the Stock Purchase Agreement – representations made to induce respondents to buy their stock. Only after the closing did Buyers learn that Alloyd's inventory and operating margin had been materially overstated.

Striving for some way to carve their transaction out of section 12(2), Sellers argue that the rescissionary remedy under section 12(2) makes sense only in the context of an initial public distribution "because the seller receives the full purchase price from the buyer and is generally the buyer's sole source of information . . . . " (Pet. Br. 27) But that is precisely what happened in this private transaction. Wind Point purchased the stock of Alloyd from Sellers, and Sellers received the consideration for the stock. While Wind Point conducted due diligence, most of its investigation consisted of discussions with Sellers and review of financial documents prepared by them.[27]

Finally, Sellers and SIA argue that it would have made no sense for Congress to create a broad remedy for all buyers under section 12(2), but not create a similar remedy for sellers. (Pet. Br. 27; SIA Br. 12) There is nothing illogical about this. The entire 1933 Act is directed at those who offer and sell securities. Congress intended to create a remedy for

[27] Indeed, in *Pinter v. Dahl*, the Court held that rescission under section 12(1) was an appropriate remedy even against a statutory seller who was not the owner of the security and did not receive the consideration paid for it. The Court explained "there is nothing incongruous about forcing a broker or other solicitor to assume ownership of the securities." 486 U.S. at 647 n.23.

buyers so that sellers would be responsible for material misstatements or omissions in touting securities. That Congress did not create a remedy *against* buyers says nothing about which buyers are entitled to the remedy created in section 12(2). Sellers' policy argument that the section 12(2) remedy "should be available to each party" to a negotiated transaction (Pet. Br. 27) is properly addressed to Congress.

III. The Legislative History Does Not Support Petitioners' Narrow Construction Of Section 12(2).

The Court has held that once it finds the terms of a statute to be clear, "judicial inquiry is complete, except in rare and exceptional circumstances." *King v. St. Vincent's Hosp.*, 112 S. Ct. 570, 575 n.14 (1991), quoting *Rubin v. United States*, 449 U.S. 424, 430 (1981). Accordingly, this Court need not address the legislative history arguments advanced by Sellers. (Pet. Br. 32-38) However, should the Court choose to address the legislative history, "[t]he 'strong presumption' that the plain language of the statute expresses congressional intent is rebutted only in 'rare and exceptional circumstances,' when a contrary legislative intent is clearly expressed." *Ardestani v. INS*, 112 S. Ct. 515, 520 (1991).[28]

Neither the legislative history specific to section 12(2) nor that of the Act as a whole compels a narrow reading of section 12(2). *See, e.g.*, Maynard, *The Future of Securities Act Section 12(2)*, 45:3 Ala. L. Rev. (forthcoming 1994) ("The legislative history of the 1933 Act does not undermine the clear import of the statute's language: that the provisions

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[28] Reliance on legislative history is particularly inappropriate in interpreting the 1933 Act because the definitions of key terms in the statute, including the definition of "prospectus," are conditioned upon the "context" in which they are used. *See* 15 U.S.C. § 77b ("When used in this subchapter, *unless the context otherwise requires*" . . .) (emphasis added). As explained above, the language and structure of the Act confirm that section 12(2) is not limited to public offerings of securities. Given that, it is inappropriate to look to legislative history to reach a different result. *See Rowland v. California Men's Colony*, 113 S. Ct. 716, 720 (1993).

of section 12(2) apply to those secondary market trading transactions that otherwise satisfy the statute's prerequisites."). The legislative history simply does not establish the "rare and exceptional circumstances" necessary to override the language and structure of the Act.

A. Nothing In The Legislative History Of Section 12(2) Establishes That The Section Is Limited To Public Sales Of Securities.

As this Court has observed, the legislative history of section 12(2) is "sparse." *Randall*, 478 U.S. at 657. Nothing in the House Report (H.R. Rep. No. 85), the Senate Report (S. Rep. No. 875), or the Conference Report (H.R. Conf. Rep. No. 152) on the 1933 Act states that section 12(2) is limited to public offerings. On the contrary, the process of reconciling the House version of section 12(2) with the Senate version evidences that Congress did not make a conscious decision to limit section 12(2) to public sales of securities.

The original Senate proposal of section 12(2) explicitly covered all false or misleading statements used to sell securities:

> Every person acquiring *any security* by reason of any false or deceptive representation made in the course of or *in connection with a sale or offer for sale or distribution of such securities* shall have the right to recover any and all damages suffered by reason of such acquisition of such securities from the person or persons signing, issuing, using, or causing, directly or indirectly, such false or deceptive representation, jointly or severally.

H.R. 5480, 73d Cong., 1st Sess. 25 (1933), as passed by the Senate with Senate amendments, 77 Cong. Rec. 2995, 2998 (May 10, 1933) (emphasis added).

The House version of section 12(2) used different language, language closer to that in the final version of the statute:

> Any person who – (2) sells a security (whether or not exempted by section 3), by the use of any means

> of instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of material fact or omits to state a material fact (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such truth or omission, shall be liable to the person purchasing such security from him. . . .

H.R. 5480, 73d Cong., 1st Sess. 25 (1933), as passed by the House on May 5, 1933, 3 Ellenberger & Maher, item 26. If Sellers' interpretation of section 12(2) were correct, the House version would, by its use of the phrase "by means of a prospectus or oral communication," apply to a significantly narrower category of transactions than the Senate version.

After the Conference Committee combined the House and Senate versions of section 12(2), the House managers attached a commentary identifying and explaining the material differences between the two bills, and how they had been reconciled. That commentary stated:

> The Senate amendment imposed liability upon persons making false and deceptive statements *in connection with the distribution or sale of a security*. The House bill made the liability depend upon the making of untrue statements or omissions to state material facts. This phrase has been clarified in the substitute to make the omission relate to the statements made in order that these statements shall not be misleading, rather than making a mere omission (unless the act expressly requires such a fact to be stated) a ground for liability where no circumstances exist to make the omission in itself misleading.
>
> The House bill (sec. 12) imposes civil liability for using the mails or the facilities of interstate commerce to sell securities (including securities exempt, under section 3, from other provisions of the bill) by means of representations which are

> untrue or are misleading by reason of omissions of material facts. The substantially similar provisions of the Senate amendment did not apply to any of the securities exempted under the Senate amendment. . . .

H.R. Conf. Rep. No. 152, 73d Cong., 1st Sess. 26-27 (1933) to accompany H.R. 5480, May 20, 1933 (emphasis added).

If the Committee had intended to narrow the scope of section 12(2) by adopting the House version, one would expect the commentary to discuss this change. It did not. The commentary's silence on the scope of section 12(2) – which would clearly have been a material point of difference – suggests that the Conference Committee saw no substantive difference between the House and Senate versions of section 12(2) on this point. *See Pacific Dunlop*, 993 F.2d at 592. A reasonable inference is that the Committee understood both the House and Senate versions to have the same broad application, and did not intend the final version to apply to a narrower class of transactions than the original Senate version.[29]

At bottom, nothing in the legislative history of section 12(2) or section 2(10) explicitly states that Congress intended to exclude private sales by controlling shareholders from the reach of section 12(2). As the Seventh Circuit observed in *Pacific Dunlop*, the Senate "rarely mentioned the word 'prospectus,' and certainly not in the fraud context of section 12(2)." *Id.* at 590-91 (footnote omitted). In light of this, the Court's observation in *Landreth* about the legislative history of the 1933 and 1934 Acts is equally applicable here:

> The history is simply silent – as it is with respect to other transactions to which these Acts have been applied by the Securities and Exchange Commission

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[29] SIA draws a contrary inference from the Conference Committee's silence – that both the House and Senate assumed that section 12(2) was limited to "the public sale of new issues." (SIA Br. 17-18) As the Seventh Circuit explai[illegible] *Pacific Dunlop*, the broad language of the Senate's version of section 12(2) demonstrates that the Senate intended to prevent fraud in *all* sales of securities. 993 F.2d at 592.

> and judicial interpretation over the half century since the legislation was adopted.

471 U.S. at 695 n.7. For fifty years, appellate courts have repeatedly upheld application of section 12(2) to privately negotiated sales of securities. The silence of the legislative history on this particular point is not a sufficient reason to override this precedent.

B. Nothing In The Legislative History Of The Act As A Whole Establishes That Section 12(2) Is Limited To Public Sales Of Securities.

Statements in the legislative history regarding the overarching purpose of the 1933 Act are similarly insufficient to narrow the scope of section 12(2). Relying on general statements of purpose from the hearings, debates and conference reports on the 1933 Act, Sellers argue that Congress must have intended to exclude privately negotiated transactions from the remedial provisions of section 12(2). As this Court has noted, however, "general remarks" that "were obviously not made with [the] narrow issue in mind" are not probative of the meaning of specific words or provisions. *Chevron*, 467 U.S. at 862, quoting *Jewell Ridge Coal Corp. v. United Mine Workers*, 325 U.S. 161, 168-69 (1945); *see also S & E Contractors, Inc. v. United States*, 406 U.S. 1, 13 n.9 (1972).[30]

Equally unconvincing is Sellers' argument that various references to "the public" in the legislative history imply that

[30] These principles are particularly applicable to Sellers' reliance on President Roosevelt's comments recommending passage of the Act. (Pet. Br. 9-10) A president's preliminary comments to Congress provide no basis upon which to interpret specific provisions in the subsequently passed Act. *Cf. Garcia v. United States*, 469 U.S. 70, 77 (1984) (general remarks of Postmaster General recommending passage of a bill did not elucidate meaning of specific statutory term). Likewise, Sellers' references to comments made in 1959 by James Landis add nothing to the analysis. (Pet. Br. 10-11) First, as Mr. Landis admits, "a sense of trepidation must . . . attach to anyone who draws upon recollections, now more than a quarter of a century old, to write the legislative history of the Securities Act of 1933." Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29, 29 (1959). Second, Mr. Landis never even discusses section 12(2) or the scope of that antifraud provision.

Congress did not intend to protect sophisticated or institutional investors from misrepresentations made to them. (Pet. Br. 38) It is far from clear that, in expressing its broad desire to protect the "investing public," Congress consciously intended to exclude purchasers in private transactions. Mutual funds and venture capital funds (such as respondent Wind Point) are the vehicles through which many members of the "public" invest their capital in both public and private corporations. There is no evidence in the legislative history that Congress even addressed these types of investors, much less intended to exclude them from seeking recompense for material misrepresentations by sellers of securities.

Finally, this Court has never read the legislative history of the Act as limiting its application solely to public offerings. Sellers cite the Court's various statements that the Act was "primarily" intended to address the problems of misleading public offerings. (Pet. Br. 18) None of the cases cited by Sellers, however, holds that the Act is applicable *only* to public offerings.[31] To the contrary, as the Court stated in *Naftalin* in summarizing the exceptionally broad purpose underlying the Act, "neither this Court nor Congress has ever suggested that investor protection was the *sole* purpose of the Securities Act." 441 U.S. at 775.

[31] Petitioners and SIA both rely on the statement in *Naftalin*, that "[u]nlike much of the rest of the act, [section 17(a)] was intended to cover any fraudulent scheme in an offer or sale of securities, whether in the course of an initial distribution or in the course of ordinary market trading." 441 U.S. at 778 (citations omitted). The Court's comment that "*much* of the rest of the act" was intended to apply to new offerings suggests that at least one provision other than section 17 was a similar departure from this intention. Because section 12(2) is "the private analogue of § 17(a)," 9 L. Loss & J. Seligman, *Securities Regulation* 4219 (3d ed. 1992), it is reasonable to infer that section 12(2) is also a "departure" from the narrower focus of the Act.

IV. Considerations Of Policy Do Not Require Limiting Section 12(2) To Public Offerings.

Sellers resort, finally, to a number of policy arguments they contend militate against construing section 12(2) to cover privately negotiated transactions. (Pet. Br. 38-41) As this Court recently stated, policy considerations "cannot override our interpretation of the text and structure of the Act, except to the extent that they may help to show that adherence to the text and structure would lead to a result 'so bizarre' that Congress could not have intended it." *Central Bank of Denver v. First Interstate Bank of Denver*, 114 S. Ct. 1439, 1453-54 (1994), quoting *Demarest v. Manspeaker*, 498 U.S. 184, 191 (1991). None of the policy arguments advanced by Sellers demonstrates that applying section 12(2) to private transactions is beyond the scope of what a rational Congress could possibly have intended.

First, Sellers argue that affording a section 12(2) remedy to purchasers in privately negotiated transactions would "effectively render superfluous Rule 10b-5 and years of precedent with respect to scienter, reliance, and loss causation under that Rule." (Pet. Br. 39) This argument makes no sense. Misrepresentations in *public* offerings, which Sellers concede are covered by sections 11, 12(2), or both, also come within the scope of Rule 10b-5, but Sellers apparently do not regard this far greater overlap as rendering Rule 10b-5 or the precedent interpreting it superfluous. As the Court stated in *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983), "it is hardly a novel proposition that the Securities Exchange Act and the Securities Act 'prohibit some of the same conduct'." *Id.* at 383, quoting *Naftalin*, 441 U.S. at 778.

Sellers' argument also ignores the differences between section 12(2) and Rule 10b-5 actions. Most importantly, Rule 10b-5 applies to a vastly broader range of transactions than section 12(2). While 12(2) is limited by a strict privity requirement, a plaintiff under Rule 10b-5 may sue anyone who made any false or misleading statement "in connection with" a purchase or sale of securities. *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971). The vast majority of Rule 10b-5 cases involve claims by purchasers of stock on the open market who sue corporate issuers, or their officers and directors, with whom they are not in privity – and thus not subject to a section 12(2) claim – for statements that allegedly resulted in a "fraud on the market." Moreover, it would be incongruous to rely on the existence of a remedy created by the courts, not by Congress, as a basis for construing narrowly a remedy expressly created by Congress. *See* 9 L. Loss & J. Seligman, *Securities Regulation* 4220 (3d ed. 1992).

Sellers' second policy argument is that a broad construction of section 12(2) "would have a drastic impact on the thousands of private transactions negotiated and closed yearly" and would "dramatically and unnecessarily increase transaction costs." (Pet. Br. 39) This argument ignores the body of case law already applying section 12(2) to such transactions. For fifty years any sophisticated party represented by competent counsel has known that the courts have applied section 12(2) to privately negotiated transactions. *See, e.g., Adena Exploration, Inc. v. Sylvan*, 860 F.2d 1242, 1244 (5th Cir. 1988) ("Sophisticated purchasers of fractional undivided interests in oil and gas have sought – and obtained – rescission of their purchases pursuant to the 1933 Act for at least thirty years."). Affirming *Pacific Dunlop* would merely maintain the status quo. It is Sellers' narrow reading of the statute that "would upset the justified expectations of both the legal and investment communities." *Reves*, 494 U.S. at 75 (Stevens, J., concurring).

Nor can a narrow reading of the statute be justified by the desire to reduce transaction costs. Contrary to Sellers' argument, applying section 12(2) to private sales of securities would not require sellers "to disclose all the information required in a registration statement." (Pet. Br. 39-40) Section 12(2) imposes liability only if the seller makes a material misstatement of fact or omits a fact necessary to make the

affirmative statements not misleading.[32] 15 U.S.C. § 77l(2). There is nothing inefficient or anti-business about requiring a party with superior information to tell the truth. Nor is it irrational or "bizarre" for Congress to impose liability on a seller who negligently makes a misstatement or omission of material fact to a party with whom he has negotiated to sell his business.

Third, Sellers argue that a broad construction of section 12(2) would improperly make federal cases out of state-law breach of contract cases. (Pet. Br. 41) The same argument could be made that the section 12(2) remedy federalizes state tort claims for negligent misrepresentation in connection with sales of securities. Both arguments are expressly addressed in section 16 of the Act, which provides: "The rights and remedies provided by this subchapter shall be in addition to *any and all other rights and remedies* that may exist at law or in equity." 15 U.S.C. § 77p (emphasis added). Indeed "an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections." *Herman & MacLean*, 459 U.S. at 388-89. Moreover, substantially fewer cases would support a section 12(2) claim than a claim for breach of contract since the former imposes liability only on a seller who is negligent while the latter requires no finding of fault, only a breach.

Finally, Sellers assert that availability of section 12(2) to purchasers in privately negotiated deals would "provide an irresistible temptation" for any disappointed buyer "to concoct a claimed misrepresentation." (Pet. Br. 41) This argument barely merits a response. There is no reason to believe that sophisticated businesspersons, represented by competent counsel, are more susceptible to this "irresistible temptation" than purchasers of shares in public offerings. If the potential

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[32] Indeed, the language of section 12(2) was changed in conference to make clear that a seller could not be held liable for all omissions, which would effectively have imposed a broad duty of disclosure under section 12(2), but only for those omissions that would make an affirmative statement by the seller misleading. H.R. Conf. Rep. No. 152, 73 Cong., 1st Sess. 26 (1933) to accompany H.R. 5480, May 20, 1933.

for frivolous lawsuits were a basis for construing statutes to deny remedies, this Court would have abolished the Rule 10b-5 cause of action years ago.

V. The Alternative Construction Proposed By *Amicus* SIA Does Not Support Reversal Of The Judgment Below.

The brief filed by *amicus* SIA focuses on an issue not presented by the facts of this case: whether section 12(2) creates a remedy against brokers and others who provide investors with research reports on corporations. (SIA Br. 1) The Court can decide the narrow question presented by this case – whether section 12(2) applies to a sale of stock by controlling stockholders in a privately negotiated transaction – without reaching this broader question. The questions raised by SIA regarding liability of brokers for research reports on publicly traded securities, availability of rescission for misrepresentations by defendants who do not receive the purchase price, and other issues regarding the outer reaches of section 12(2) are not before the Court and need not be resolved in this case.[33]

In support of its position that section 12(2) should not reach misstatements by brokers and others who are not the owners of the securities being sold, SIA proposes a construction of section 12(2) different from that urged by Sellers. SIA argues that section 12(2) applies only to initial distributions of securities, which it defines as "initial public offerings" and "subsequent public offerings by an issuer." (SIA Br. 2 & n.2) In other words, SIA asserts, section 12(2) applies only to the "public distribution of newly issued securities." (*Id.* at 4) This construction has no more basis in the text and structure of the Act than Sellers'.

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[33] This Court has repeatedly declined to address questions not raised by the petitioner and argued for the first time in the brief on an *amicus curiae*. *See, e.g.*, *Kamen v. Kemper Fin. Services, Inc.*, 500 U.S. 90, 97 n.4 (1991); *United Parcel Service, Inc. v. Mitchell*, 451 U.S. 56, 60 n.2 (1981).

A. SIA's Alternative Reading Of Section 12(2) Is Not Supported By The Text, Structure, Or Legislative History Of The Act.

SIA's argument that section 12(2) is limited to "initial distributions of securities" suffers from the same threshold infirmity as Sellers' argument: the text and structure of the statute do not expressly provide such a limitation. This Court should reject SIA's invitation to make up a limitation that Congress did not enact.

Section 12(2) on its face refutes SIA's argument that it applies only to "initial public offerings and subsequent public offerings *by an issuer*." (SIA Br. 2 n.2, emphasis added) The section explicitly applies to "[a]ny person" who offers or sells a security; it is not limited to "issuers" who offer or sell. Moreover, section 2(10) defines "sale" and "sell" to include "*every* contract of sale or disposition of a security" and defines "offer" to include "*every* attempt or offer to dispose of, or solicitation of an offer to buy, a security." 15 U.S.C. § 77b(3) (emphasis added). The other sections of the Act, such as section 11, demonstrate that when Congress intended a particular provision to apply to "issuers" or other specific categories of persons, it made this explicit. That it did not do so in section 12(2) is dispositive of this point.

Like the argument of Sellers, SIA's textual argument relies primarily on the use of the phrase "by means of a prospectus or oral communication."[34] (SIA Br. 4-9) SIA's argument that "prospectus or oral communication" should be read as limited to initial offerings by issuers is no more persuasive than Sellers' public/private limitation. The terms used in defining "prospectus" cannot be read as limiting section 12(2) to misleading statements made only in initial offerings of stock. Had Congress intended to limit section 12(2) to this specific category of securities transactions, it would have done so explicitly, not indirectly.

[34] SIA also argues that "prospectus" limits section 12(2) to "public" offerings. (SIA Br. at 7-9) That argument is addressed in section I, C above, and will not be repeated here.

Equally unconvincing is SIA's structural argument that section 12(2) must be construed narrowly because sections 11 and 12(1) provide civil remedies only for "violations that arise in the course of initial offerings." (SIA Br. 9-10) Section 11 by its terms clearly applies to a registered secondary offering of existing shares, whether sold by the issuer or by a stockholder. 15 U.S.C. § 77k(a). Similarly, section 12(1) applies to a public secondary sale of unregistered shares by a stockholder deemed to be an underwriter under the Act and thus not entitled to exemption under section 4. *See id.* § 77d(1); 7B J. Hicks, *Exempted Transactions Under the Securities Act of 1933* § 9.03[1], at 9-180 to 9-182 (1st ed. 1994). In short, SIA is incorrect in asserting that the provisions of sections 11 and 12(1) – and thus 12(2) – are limited to "the universe of possibilities in an initial distribution." (SIA Br. 9-10)

Nor is there any basis in the structure of the Act or the definition of "prospectus" for limiting section 12(2) to "newly issued securities." If a large shareholder of a corporation decides to make a registered public secondary offering of the corporation's stock, that offering may be of existing shares or newly issued shares. Whether the shares are existing or newly issued, misrepresentations in the registration statement would be subject to section 11's remedies. Under SIA's reading, however, there would be section 12(2) liability for misstatements in the prospectus only in one case.

The agencies responsible for enforcing the Act have long held the view that section 12(2) is not limited to newly issued securities or initial offerings. Shortly after the Act was signed into law, the Federal Trade Commission, the agency initially responsible for administering the Act, issued a release explaining the effective dates of the various provisions of the Act. The release stated that both sections 12(2) and 17(a) "apply to outstanding securities as well as to new issues which are to be placed in the market after registration." *Effective Dates of Securities Act of 1933 Are Explained*, 1933 SEC LEXIS 8, at 2 (June 2, 1933).

The SEC has similarly stated that section 12(2) is not limited to initial distributions of stock. In a 1941 report to the

House of Representatives, the SEC stated: "Section 12(2) of the act permits a purchaser to recover from a person who has sold securities to him on the basis of untrue statements or misleading omissions. It does not distinguish between sellers engaged in a distribution subject to registration and those selling outstanding securities." House Comm. on Interstate and Foreign Commerce, *Report of the Securities and Exchange Commission on the Proposals for Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 77th Cong., 1st Sess. 14 (Comm. Print 1941). As discussed above, these early interpretations by the agencies responsible for enforcing the Act are entitled to substantial weight.

The legislative history arguments advanced by SIA (SIA Br. 13-18) are generally duplicative of those advanced by Sellers. For the reasons explained above, there is no definitive legislative history demonstrating that Congress intended to limit section 12(2) to initial distributions of securities. SIA's additional arguments should be rejected for three reasons.

First, the individuals principally involved in drafting the Act expressed the contemporaneous view that section 12(2) applies to aftermarket transactions. For example, Arthur Dean, who consulted with the House Commerce Committee during the drafting process, and then-professor Felix Frankfurter, the head of the team that drafted the Act, both wrote that section 12(2) applies to secondary transactions as well as initial distributions.[35] That view was echoed even by early critics of the Act. For example, an American Bar Association committee seeking an amendment to the civil liability provisions noted that section 12(2) "is not confined to those sellers who have special sources of information but applies to all sellers of securities." *Report of the Special Comm. on Amendments to the Securities Act of 1933*, 59 Rep. A.B.A. 565, 578

[35] *See* Dean, *The Federal Securities Act: I*, 8 Fortune 50, 102 (1933) (section 12(2) applies to "anyone selling any security including outstanding securities . . . or securities exempt from registration . . . "); Frankfurter, *The Federal Securities Act: II*, 8 Fortune 53, 108 (1933) (the Act applies to "the sale of all private or foreign government securities, new or old.").

(1934). With a few recent exceptions, commentators have also consistently said that section 12(2) is not limited to initial offerings.[36]

Second, SIA acknowledges that "the scope of the 1933 Act is not limited exclusively to initial offerings," but then argues for a narrow construction of section 12(2) because nothing in the legislative history indicates Congress intended to broaden the scope of section 12(2) beyond initial distributions. (SIA Br. 14) That argument turns the issue on its head. Given that the Act as a whole is not limited to initial offerings and section 12(2) does not contain such an express limitation, there is no reason to demand legislative history justifying application of section 12(2) to secondary offerings.

Third, SIA cites to numerous comments by individual Members reflecting their views on the supposed purpose of the Act. (*See, e.g.*, SIA Br. 15-17) However, this Court has repeatedly "eschewed reliance on the passing comments of one Member, and casual statements from the floor debates." *Garcia v. United States*, 469 U.S. 70, 76 (1984) (citations omitted); *see also Chrysler Corp. v. Brown*, 441 U.S. 281, 311

[36] *See, e.g.*, L. Loss, *Securities Regulation* 996-97, 1006-08 (1951); 3 L. Loss, *Securities Regulation* 1699, 1712 n.89 (2d ed. 1961); 9 L. Loss & J. Seligman, *Securities Regulation* 4217-4222 (3d ed. 1992); 3A H. Bloomenthal, *Securities and Federal Corporate Law* § 8.05[3], at 8-43 to 8-44.8 (1993); 2 A. Bromberg & L. Lowenfels, *Securities Fraud & Commodities Fraud* § 5.2, at 600 (1993); 1 T. Hazen, *The Law of Securities Regulation* § 7.5, at 318 (2d ed. 1990); 17A J. Hicks, *Civil Liabilities: Enforcement and Litigation Under the 1933 Act* § 6.01[3], at 6-12 to 6-30 (1993). Several recent articles reach the same conclusion. *See, e.g.*, Maynard, *Section 12(2) of the Securities Act of 1933: A Remedy for Fraudulent Postdistribution Trading?*, 20 Sec. Reg. L.J. 152 (1992); Rapp, *The Proper Role of Securities Act Section 12(2) as an Aftermarket Remedy for Disclosure Violations*, 47 Bus. Law. 711 (1992). Recently, contrary views have been expressed in Weiss, *The Courts Have It Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 Bus. Law. 1 (1992), and Prentice, *Section 12(2): A Remedy for Wrongs in the Secondary Market?*, 55 Alb. L. Rev. 97 (1991).

(1979) ("[t]he remarks of a single legislator, even the sponsor, are not controlling in analyzing legislative history").

In sum, the statutory text and structure support the Seventh Circuit's reading of section 12(2), and the legislative history does not provide the kind of unambiguous evidence necessary to dictate a contrary construction. Construing section 12(1) of the Act in *Pinter*, this Court held that "[w]e must assume that Congress meant what it said." 486 U.S. at 653. The Court should similarly reject SIA's attempt to read into section 12(2) a limitation that Congress did not put there.

B. SIA's Proposed Construction Is Inconsistent With The Remedial Purpose Of The Act And Not Required By Any Compelling Policy Concerns.

Construing section 12(2) as limited to sales of newly issued stock by issuers would exempt from the civil remedies of the Act numerous securities transactions for which the negligence-based remedy is particularly appropriate. For example, there is no sound policy rationale for excluding from section 12(2) substantial secondary offerings by shareholders of either public or private corporations. The interests of the purchaser in having truthful information about the securities is the same in either case.

SIA's policy argument that potential section 12(2) liability will chill the dissemination of analysts' reports is unfounded and goes well beyond the issue presented by the facts of this case. This argument is apparently based on SIA's misreading of *Pacific Dunlop* as holding that section 12(2) applies to any material misstatements or omissions made "in connection with" the sale of a security. As discussed above, the holding of *Pacific Dunlop* is not so broad. The Seventh Circuit in *Pacific Dunlop* held that section 12(2) applies to misrepresentations in written or oral communications that offer securities for sale or confirm the sale of a security. Thus, the court did not construe the civil remedy as extending beyond those statements, either written or oral, made during the actual selling process.

It is far from obvious that an analyst's report summarizing the current business and future prospects of a company constitutes a communication that offers a security for sale or confirms the sale of a security.[37] In any event, this issue was neither raised by the parties nor addressed by the courts below, has not adequately been developed by other lower courts, and thus need not be decided in this case. Similarly, if analysts' reports may in some circumstances come within the definitions of "prospectus," it is not clear how high the threshold is for a brokerage firm to establish that it was not negligent. Again, this is an issue that requires development in the lower courts and need not be resolved in order to decide this case.

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[37] The extent of brokers' liability for their research reports under section 12(2) raises the issue left open by the Court in *Pinter*, 486 U.S. at 642 n.20. In *Pinter*, the Court held that a nonowner of securities who solicits another to purchase, motivated by a desire to serve his own financial interests or those of the owner of the securities, is a statutory "seller" under section 12(1). The Court did not decide whether the same analysis applied to section 12(2), and need not address this issue here because Sellers were the owners of the stock and passed title to Buyers.

CONCLUSION

For the reasons stated above, the judgment of the court of appeals should be affirmed.

Respectfully submitted,

ROBERT J. KOPECKY*
BRIAN D. SIEVE
CAROLE A. CHENEY
JONATHAN F. PUTNAM
KIRKLAND & ELLIS
200 East Randolph Drive
Chicago, Illinois 60601
(312) 861-2000

KENNETH W. STARR
PAUL T. CAPPUCCIO
KIRKLAND & ELLIS
655 Fifteenth Street, N.W.
Washington, D.C. 20005
(202) 879-5000

Counsel for Respondents

June 29, 1994

*Counsel of Record

(10)

No. 93-404

In The

Supreme Court of the United States

October Term, 1994

ARTHUR L. GUSTAFSON, DANIEL R. McLEAN and FRANCIS I. BUTLER,

Petitioners,

v.

ALLOYD CO., INC. and WIND POINT PARTNERS II, L.P.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

REPLY BRIEF

DONALD W. JENKINS*
THOMAS P. DESMOND
JENNIFER R. EVANS

VEDDER, PRICE, KAUFMAN & KAMMHOLZ
222 North LaSalle Street
Chicago, IL 60601
(312) 609-7500

Counsel for Petitioner Arthur L. Gustafson

*Counsel of Record

HAROLD C. WHEELER*
PETER C. WOODFORD
DEBRA A. WINIARSKI

SEYFARTH, SHAW, FAIRWEATHER & GERALDSON
55 East Monroe Street
Chicago, IL 60603
(312) 346-8000

Counsel for Petitioners Daniel R. McLean and Francis I. Butler

*Counsel of Record

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

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INTRODUCTION

The primary purpose of the Securities Act of 1933, 15 U.S.C. §§ 77a-zzz (1994) [hereinafter the "Act"] was to regulate public offerings of securities without undue interference with private business. The civil liability provisions of the Act, which make a seller of securities a fiduciary, are justified only in that context.

> "Their essential characteristic consists of a requirement that all those responsible for statements **upon the face of which the public is solicited to invest its money** shall be held to standards like those imposed by law on a fiduciary."

H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933) [hereinafter the "House Report"] (emphasis added). Such fiduciary liability is imposed by Section 12 when a seller makes a public offering but (i) fails to comply with the Act's registration requirements or (ii) sells such securities "by means of a prospectus or oral communication" which includes a misstatement or omission. 15 U.S.C. § 77l (1994). As to either violation, a buyer need not show reliance and is allowed recision as a remedy irrespective of the damages actually caused by the violation. As to unintentional misstatements or omissions, a seller can avoid liability only by sustaining the burden of proving he could not have discovered the truth in the exercise of reasonable care. *Id.* In sum, Section 12 makes a seller a fiduciary of a buyer of securities.

Treatment of one selling to the public as a fiduciary is fair but such treatment makes no sense in the context of private negotiated transactions among parties able to fend for themselves. For this reason, "[t]he committee emphasizes that these liabilities attach **only** when there has been an untrue statement of material fact or an omission to state a material fact **in the registration statement or the prospectus – the basic information on which the public is solicited.**" House Report at 9 (emphasis added).

That the Act does not make a seller in a negotiated private transaction a fiduciary is demonstrated by Section 12(2)'s use of the phrase "offers or sells a security . . . by means of a prospectus or oral communication" which must, particularly considered in light of the purpose of the Act and the context of the phrase in Section 12, be read to impose this new federal liability only on those who sell securities to the public.

Despite Buyers' suggestion to the contrary, Sellers do contend that Section 12(2) does not apply to ordinary aftermarket trading transactions as the court held in *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d. 682 (CA3), *cert. denied*, 112 S.Ct. 79 (1991). That holding and the arguments of the Securities Industry Association ("SIA") are consistent with and complement Sellers' contention that the Section was never intended to cover private transactions. This Court need only decide here, however, that secondary transactions that bear no resemblance to an initial offering are not covered by Section 12(2) or that a negotiated private stock purchase agreement is not a prospectus within the meaning of Section 12(2).

A decision that Section 12(2) applies in all contexts to "the full array of communications used to sell securities" (Resp. Br. at 14) will affect dramatically the ability of parties to negotiate desired private agreements. It would also make all sellers of securities in millions of ordinary aftermarket transactions fiduciaries of those to whom they sell. Confirming that the Section, like the other civil remedies of the Act, only makes a seller a fiduciary in the context of public offerings will facilitate ordinary aftermarket trading and allow private parties able to fend for themselves to negotiate their transactions without either party being treated as a fiduciary of the other. This is reasonable and proper because all such private parties have ample protection through their contractual rights, their rights under state law and the antifraud provisions of Rule 10b-5. 17 C.F.R. § 240.10b-5, (1992) [hereinafter "Rule 10b-5"].

SUPPLEMENTAL STATEMENT OF THE CASE

Buyers make many immaterial, and sometimes misleading, factual claims, largely by citing to inferences the magistrate observed *might* be made in Buyers' favor which she believed required denial of Sellers' Motion for Summary Judgment. The District Court has not accepted or rejected the Magistrate's recommendation. Sellers deny many of Buyers' factual allegations and submit that no misstatement was made even if there was an inventory shortfall (which Sellers deny and which cannot now be determined since no interim inventory was taken), because Buyers *knew* that Alloyd's inventory was estimated and would be adjusted – possibly materially; the ultimate adjustment was immaterial because Buyers were compensated for it pursuant to the price adjustment provision in the Agreement; Buyers knew *all* material information about Alloyd since McLean and Butler reinvested in and were officers of Buyer; and Buyers' effort to rescind is due to changed market conditions – not any misstatements by Sellers. A review of the Magistrate's recommendation does, however, demonstrate the unfair evidentiary burden which should not be imposed on a seller in a negotiated private transaction.

What happened here is clear. Dissatisfied in retrospect with their deal, Buyers seek to invoke the Act's anti-waiver provision (15 U.S.C. § 77n) and rescind their purchase based on claimed inadvertent misstatements by Sellers in the very contract Buyers seek to otherwise ignore. They base their claim on their strained interpretation of oral comments even though the Agreement provided that its representations "supersede any prior understandings, agreements or representations by or between the parties, written or oral" (JA 160). They seek recision even though their contract stated that Buyer "expressly waives any and all rights it may have to seek the remedy of recision against Sellers" (JA 149).

Buyers claim an innocent misstatement – not fraud. The unfairness of making Sellers a fiduciary of Buyers in

this private transaction is clear. Also clear is the unfairness of allowing Buyers to rescind their purchase irrespective of the damage – if any – they actually suffered. Such unfairness is perhaps the best indication that Section 12(2), like the other civil liability provisions of the Act, was limited to public offerings and never intended to make sellers fiduciaries in negotiated private transactions among parties able to fend for themselves.

SUMMARY OF REPLY

The following key contentions of the Briefs of Sellers and the SIA demonstrate separately, and certainly in the aggregate, that Section 12(2) does not extend to this negotiated private transaction:

– the primary purpose of the Act was to regulate public offerings of securities while interfering as little as possible with regular business;

– legislative history confirms that all of the Act's civil liability provisions applied only in the context of public offerings and there is no legislative history to the contrary;

– "offers or sells . . . by means of a prospectus or oral communication" is a limiting phrase demonstrating, as compared to the language of Section 17(a) or the obvious alternative "by means of any communication", that Section 12(2) was only applicable in the context of public offerings;

– the context of Section 12(2) – together with the public offering remedies of Sections 11 and 12(1) – confirm that the remedy applied only in the context of public offerings;

– since the Act, including Section 12(2), did not apply to private transactions there was no need to "exempt" such transactions from Section 12(2)'s coverage; and

– making a seller in a negotiated private transaction a fiduciary of the buyer makes no sense given the total scheme of the Act and would reflect very poor public policy.

ARGUMENT

A. THE PURPOSE AND STRUCTURE OF THE ACT SHOW THAT ITS CIVIL LIABILITY PROVISIONS ONLY APPLY IN THE CONTEXT OF PUBLIC OFFERINGS

"Public offerings" as distinguished from "private offerings" defined the exact scope of what the drafters wanted the Act to cover since private offerings were "not a matter of concern to the federal government." J. Landis, *The Legislative History of the 1933 Securities Act*, 28 Geo. Wash. L. Rev. 29, 37 (1959). The bill "carefully exempts from its application certain types of securities and securities transactions where there is no practical need for its application or where the public benefits are too remote." House Report at 5 (emphasis added).[1]

The issue here is whether Section 12(2) represents a significant departure from the Act's limited application by making a seller of securities a fiduciary of the buyer in all contexts. If so, it is simply inconceivable that the legislative history related to the Act in general or Section 12(2) in particular would be totally silent as to that intent. If, however, the Section merely complemented Sections 11 and 12(1) and all were limited in their application to the

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[1] The desire of Buyers and the SEC to avoid consideration of legislative history is understandable in light of its powerful showing that the civil remedies in the Act applied only in the context of public offerings and their inability to show *any* legislative history to the contrary. The legislative history should be given proper weight here, and certainly much more weight than the attempts, particularly by the SEC, to demonstrate intent of the Act by reference to statements in the popular press and unauthenticated comments in unpublished materials.

context of public offerings, the lack of discussion of Section 12(2) makes perfect sense.[2]

The registration and prospectus delivery requirements are the heart of the Act, serving in tandem to assure broad and accurate dissemination of information in public offerings. *See Pinter v. Dahl*, 486 U.S. 622, 638 (1988); E. Weiss, *The Courts Have it Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 Bus. Law. 1, 9 (1992) [hereinafter "Weiss"]. The *only* detailed explanation of the role and purpose of the Act's civil liability provisions was in the House Report, which makes clear their application only in the context of public offerings:

> Sections 11 and 12 create and define the civil liabilities imposed by the act and the machinery for their enforcement which renders them practically valuable. Fundamentally, these sections entitle the buyer of securities **sold upon a registration statement including an untrue statement or omission of material fact**, to sue for recovery of his purchase price, or for damages not exceeding such price, those who have participated **in such distribution** either knowing of such untrue statement or omission or having failed to take due care in discovering it. The duty of care to discover varies in its demands upon **participants in securities distribution** with the importance of their place **in the scheme of distribution** and with the degree of protection that **the public** has a right to expect.

Id. at 9 (emphasis added). All of the articulated justifications for the fiduciary remedy of Section 12 were based on the reasonableness and fairness of imposing fiduciary

[2] Buyers assert that Seller's construction of Section 12(2) creates a significant "gap" in the remedial structure of the Act by limiting the class of buyers covered by the Act. (Resp. Br. at 28) This is a *non sequitur* because the Act's other civil remedies plainly apply only in the public offering context, thus affording relief only to a select group of buyers – *buyers in a public offering*.

liability on those soliciting the public to invest. Making sellers engaged in public offerings fiduciaries of buyers and imposing a recision remedy irrespective of damage actually caused by a misrepresentation were appropriate because the common law "was not consciously molded for the *flotation* of securities." H. Shulman, *Civil Liability and the Securities Act*, 43 Yale L.J. 227 (1933) [hereinafter "Shulman"] (emphasis added). Excusing buyers from showing "reliance" on misstatements in public offerings was reasonable since such misstatements, "because of their wide dissemination, determine the market price of the security." House Report at 10. Imposing the burden of proof of exercise of reasonable care was plainly fair as to "those who purport to issue statements *for the public's reliance*." *Id.* at 9. Finally, no unfair burden was imposed by Section 12 since, in the context of a public offering, avoidance of liability under the Section was not difficult. "Once it is determined that registration and prospectus are necessary, it cannot be unduly difficult to ascertain whether a registration statement is in effect and what prospectus satisfies the requirements of Section 10." Shulman at 243.

Section 12, since perceived to be applicable only in the context of public offerings, did not invoke much criticism. *Id.* at 242. Such lack of criticism simply cannot be squared with any notion that Section 12(2) made all sellers of securities fiduciaries in all contexts. Such a new federal remedy in purely private or intrastate contexts would have raised constitutional uncertainties as well as opposition on the ground that it represented an unwarranted intrusion of the federal government into private and intrastate business affairs. The House Report at 10 noted that to impose responsibility beyond those who purport to issue statements *for the public's* reliance "apart from constitutional doubts, would unnecessarily restrain the conscientious administration of honest business with no compensating advantage to the public." The House Report also specifically referenced the constitutional rationale for the liability provisions of the bill, stating:

> The constitutionality of the imposition of liabilities of the character provided by the bill raises no serious concerns. Even though the activities of the particular persons concerned may be actually intrastate in character, they are, nonetheless, *an integral part of a process calling for the interstate distribution of securities.*[3]

Id. at 10 (emphasis added). There would plainly have been significant criticism if Section 12(2) had been perceived as broader than the rest of the Act and applicable to all communications in all contexts, even private and intrastate transactions. The lack of such criticism of Section 12(2) is certainly telling as to the perceived scope of the coverage of the Section.

Equally telling were the criticisms that the Act's coverage should have extended to transactions involving "old stock". SIA Br. at 15-17. Not one of the Act's proponents responded that Section 12(2) made a seller a fiduciary in such transactions. Rather, the response was to explain the bill's exclusive focus on initial public offerings and its inapplicability to the secondary market – regulation of which was a matter "left for subsequent and much-needed legislation." Comments of Sen. Norbeck, 77 Cong. Rec. 3223 (1933).[4] Such criticisms and responses plainly show that the remedy of Section 12(2) was not believed to apply in any context other than public offerings.

H.R. 5480, 73d Cong. 1st. Sess. (1933) [hereinafter "House Bill"] was the bill that formed the basis for the

[3] *See also* comments of Rep. Cox ("A prospectus is not a thing of value, it is not even intercourse, and therefore is not in commerce, and not subject to the control of Congress.") 77 Cong. Rec. 2938. *See generally* Isaacs, *The Securities Act and the Constitution* 43 Yale L.J. 218 (1933).

[4] The observation of Buyers and the SEC that Rule 10b-5 was adopted much later misses the point of Sellers' argument which is simply that the declared intent of Congress to regulate aftermarket activity in a later act shows its understanding that such regulation had not already occurred by virtue of Section 12(2).

Act. *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 590 (CA7 1993), *cert. granted*, 114 S.Ct. 907, *cert. dismissed*, 114 S.Ct. 1146 (1994) acknowledges that: "Based on the House Report, the legislative history of the 1933 Act can be read to focus on those offerings requiring a registration statement, or as the Third Circuit interprets, to initial offerings." The SEC properly acknowledges that the first House bill and its Senate counterpart "expressly provided that the remedy for securities purchasers based on misrepresentations *was not applicable in private or aftermarket transactions.*" SEC Br. at 15, n. 16 (emphasis added). The SEC claims this original limited coverage was expanded dramatically in the final Act but fails to identify effectively any change or comments reflecting the expansion.[5] There were none because the claimed expansion never occurred.

Buyers, in conflict with the SEC, contend the original Senate bill, S. 875, 73d. Cong., 1st Sess. (1933) [hereinafter "Senate Bill"] covered private transactions by citing only Section 9 of that bill and ignoring the bill's Section 12(c) which exempted private transactions from the entire bill. *Pacific Dunlop* reached the same erroneous conclusion noting Section 12(c) but failing to recognize the breadth of its scope.[6] Buyers and *Pacific Dunlop* support their

[5] In support of this assertion, the SEC references only (a) movement of the remedy from Section 11 to Section 12 but the latter Section was as clearly applicable to public offerings as the former; and (b) the narrowing of Section 4's exemptions to make them exemptions only from Section 5. This, however, begs the question of whether Section 12(2) applies to the exempted transactions in the first place.

[6] Section 12(c) of the Senate Bill provided: "Except as hereinafter otherwise expressly provided, the provisions *of this Act* shall not apply to . . . Isolated transactions. . . . " H.R. 5480 as passed by Senate, § 12. No subsequent provision of the Senate bill provided that the "isolated transaction" exemption should not apply to Section 9. Treating Section 9 as itself so providing, as the Seventh Circuit appeared to do, clearly would be error, since Section 9 appears *before* Section 12 and in any event does not "expressly provide" that it applies to "isolated transactions".

respective positions by reference to the Conference Committee Report. H. Rep. No. 152, 73d Cong., 1st Sess. (1933) [hereinafter "Conference Committee Report"]. Resp. Br. at 35-37; *Pacific Dunlop* at 591-92. Both references are erroneous and it is noteworthy that the SEC does not join in either of their arguments. *See* SEC Br. at 15.

The treatment by the Conference Committee can only be understood by considering the differences in the bills the Committee addressed. The Senate Bill contained a broad civil liability provision (Section 9) applicable on its face to all sales of securities but by Sections 11 and 12 exempted *from the entire bill* various securities and private and aftermarket transactions. The House Bill exempted certain securities *from the entire bill* but by Section 12(2) provided specifically that Section 12(2) applied to the exempt securities. The House Bill also contained narrower civil liability provisions (identical in all material respects to Sections 11 and 12 as finally adopted) applicable only to public offerings (as evidenced by Section 13 of the House Bill which prohibited actions under Sections 11 and 12 more than ten years after the securities were "offered to the public").[7]

Because neither bill contained civil liability provisions applicable to private or aftermarket transactions, the bills had "substantially similar provisions" in that respect as the Committee noted. The only material difference between the Bills' respective liability provisions

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[7] Buyers cite Section 13's *amended* version which uses "offered to the public" in reference to claims under Section 12(1) and "after the sale" in reference to claims under Section 12(2) as evidencing broader coverage by Section 12(2). Resp. Br. at 26 n.18. The reference does not help Buyers. Section 12(1) is violated by the failure to register a public offering and the commencement date of the offer is the reference point. As to Section 12(2) the violative conduct occurs when a misleading prospectus is delivered which might be significantly later than the initial public offering. Plainly, it makes sense to use the sale date as the reference point as to such claims. The amendment was nothing more than a clarification and did not create new coverage where none existed previously.

concerned whether sellers would be liable for misstatements in public offerings of exempt securities.[8] The Committee noted *this difference* (in treatment of exempt securities) as the only significant difference between the otherwise "substantially similar provisions" of the bills and the House Bill's application of Section 12(2) to public offerings of such securities was confirmed, except that "government securities" were excluded. Conference Committee Report at 26-27.

The court in *Pacific Dunlop* and Buyers incorrectly construe the Committee's reference to "the substantially similar provisions" as confirming that the Committee equated the liability provisions in the two bills construing both as applicable to "private transactions." *Pacific Dunlop* at 591, Resp. Br. at 36-37.

In sum, Buyers, the SEC and *Pacific Dunlop* argue, in conflicting manners, that although the language remained the same, the coverage of Section 12(2) evolved from "public offerings" to "all transactions" as the Act was adopted. *Nothing*, however, in the language, language changes or legislative history of the Act suggests such an evolution. It simply defies belief that such a fundamental change was made intentionally but without comment.

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[8] The Conference Committee's decision to subject sellers of securities exempted from registration by Section 3 of the Act, 15 U.S.C. § 77c, to Section 12(2) liability does not change the conclusion that Congress intended Section 12(2) to apply only to public offerings. The types of securities covered under Section 3 either already faced some form of outside regulation or possessed diminished potential for fraud. Still, if the distribution of such securities is a public offering Section 12(2) would apply to protect the public.

B. THE LANGUAGE OF SECTION 12(2) SHOWS THAT IT ONLY APPLIES TO PUBLIC OFFERINGS

The *Ballay* court analyzed Sections 12(2) and 2(10) of the Act and concluded "that Congress employed the term 'prospectus' as a term of art which describes the transmittal of information concerning the sale of a security in an initial distribution." *Ballay* at 688.

The interpretation of Section 12(2) advanced by Buyers and the SEC depends almost entirely on what they contend is the "plain meaning" of Sections 12(2) and 2(10) 15 U.S.C. § 77b(10). Considering *only* the language used in Section 12, however, it is more reasonable than not to conclude that Section 12(2) applies only to public offerings, as does Section 12(1) which it follows and with which it shares common language defining who is liable, who can sue, and the remedy provided. In addition, to read "by means of a prospectus or oral communication" as anything other than a phrase of limitation would strip it of all meaning.[9] Had Congress intended Section 12(2) to apply to all sales of securities, it would have made that section applicable to any person who "offers or sells a security . . . by means of any untrue statement of a material fact or any omission to state a material fact necessary. . . . " *Compare* Section 17(a). Congress' failure

[9] Respondents' Brief does not even attempt to respond to this compelling observation and the SEC's response is merely that "The Securities Act is characterized by the use of phrases intended to denote breadth and emphasis, even if a briefer formulation might have been available." SEC Br. at 9-10. This assertion, however, begs the question by assuming – without basis – that Congress intended such "breadth" rather than "limitation." Equally weak is the SEC's claim that use of "prospectus or oral communication" was "a useful way to underscore that Congress intended to cover not just written communications, but also broadcasts and oral statements." SEC Br. at 9. It would have been much more enlightening and clarifying and thus "useful" for Congress to have simply said "any communications" or "any written or oral communications" if that is what was really intended.

to adopt that broader and more straightforward language must be honored. *See Reves v. Ernst & Young*, 113 S.Ct. 1163, 1169 (1993). Finally, "by means of a prospectus" must refer to sales by means of the sort of document – a "prospectus" – that typically is used when securities are sold to the public.[10]

The "plain meaning" of Section 12(2), if read in isolation, is that it applies only to public offerings of securities. With that meaning, it becomes clear how Section 12(2)'s remedy is properly applied in the context of public sales of securities otherwise exempt from the Act.

Buyers and the SEC argue that Section 12(2) must be read in light of the language of Section 2(10), which defines "prospectus". However, they misread Section 2(10) which in 1933 defined prospectus as meaning "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio, *which offers* any security for sale." (emphasis added). These words can only be regarded as limiting the universe of communications being referenced.[11] While the words "letter, or communication" in Section 2(10) are more generic in scope, their placement in Section 2(10) can only be deemed to refer to

[10] Such a construction is, as discussed above, shown by the initial version of Section 13 and also shown by the very early releases of the FTC regarding effective dates for application of various sections of the Act. The June 2, 1933 Release speaks in terms of Section 12(2)'s application to "outstanding securities as well as to new issues which are to be *placed on the market* after registration." *Effective Dates of Securities Act of 1933 Are Explained*, Securities Act of 1933, Rel. No. 3, 1933 SEC LEXIS 8 at 2 (June 2, 1933).

[11] Significantly, the list does not include the very type of document primarily at issue here, namely a contract or agreement. All sales occur by means of some form of oral or written contract or agreement. It is inconceivable that Congress would not have included those words in the list if Congress really intended that prospectus have the broad meaning Buyers ascribe to the word.

letters or communications akin to an advertisement.[12] To construe these terms otherwise renders all the words preceding them in Section 2(10) mere surplusage – clearly an improper construction. *See Reves v. Ernst & Young*, 113 S.Ct. 1163, 1169 (1993).

The words used in Section 2(10) refer only to communications used to solicit the public. If Section 2(10)'s list of terms defining "prospectus" was meant to have the breadth claimed by Buyers, Congress would have simply define "prospectus" as "any communication which offers a security." The language and structure of Section 2(10) demonstrate that its listing of the communications that can constitute a "prospectus" is limited to communications that, like a prospectus, offer securities to the public. A privately negotiated contract of sale, the alleged "prospectus" in the instant case, does not fall within that definition.

Buyers and the SEC also fail to give proper consideration to the "context" clause of Section 2(10). The SEC acknowledges that in some contexts a "prospectus" does not mean "any communication." SEC Br. at 10. It claims that Section 12(2) is not such a context but does not explain why. The only "authority" the SEC really quotes setting forth any explicit claim as to the scope of coverage intended by Section 12(2) are lobbyist groups' alarmist articulations as to the feared breadth of a provision. This "authority" is entitled to no weight whatsoever. The failure to affirmatively legislate in response to the alarmist concern means nothing if the concern was misplaced in the first place.

[12] Securities Act of 1933, Rel. No. 54 1933 SEC LEXIS 59 at 2 (Oct. 13, 1933) spoke in terms of Section 12(2) applying to securities being "advertised" stating that old securities could be "*advertised in any form*, subject only to the limitations of Sections 12(2) and 17 imposing civil and criminal liability for material misstatements and omissions." By its very use of "advertised" – as opposed to "sold" – the SEC was implicitly construing "prospectus" as Sellers assert the term was intended to be construed.

Buyers and the SEC argue, in essence, that while Section 12(2) should not itself be read in isolation, it is nonetheless appropriate to read Sections 12(2) and 2(10) collectively in isolation from the other sections of the Act. Section 2(10) *must*, as its "context clause" anticipates, be read in relation to the other provisions of the Act, most notably Section 5, 15 U.S.C. § 77e. To ensure the effectiveness of Section 5(b)(1)'s prohibition of dissemination of any written selling materials to prospective purchasers in a *public* offering prior to delivery of a final prospectus, Section 2(10) defines as a "prospectus" any written communication or broadcast selling materials sent to a prospective purchaser.[13] Nothing in the Act supports the view that Congress intended to bring within its definition of "prospectus" communications that offered a security for sale in other contexts. Similarly, nothing in the language of Sections 2(10) or 12(2) supports the view that Congress intended to treat communications that do not relate to a public offering as a "prospectus," for purposes of Section 12(2).

In fact, it is clear that the Section 2(10) definition of "prospectus" *cannot* be imported wholly into Section 12(2). The second part of Section 2(10) excludes from its definition of "prospectus" written selling materials (or a confirmation) that a seller delivers to a prospective purchaser after the seller has delivered a statutory prospectus. Even though Section 2(10) provides that such materials are *not* a prospectus, Section 12(2) clearly applies to misstatements in such materials. House Report at 13. While the portion of Section 2(10) excluding such materials from the definition makes sense after the information requirements of Section 5 are satisfied, it does not

[13] Buyers claim SEC Rel. No. 33-2623, 11 Fed. Reg. 10964 (July 25, 1941) shows that the SEC has consistently interpreted "prospectus" to include a broad range of written selling communications. (Resp. Br. at 23) In fact, however, the release discusses the term "prospectus" solely in relation to Section 5's prohibition on dissemination of written selling materials prior to delivery of a statutory prospectus.

make sense in the context of Section 12(2), strongly suggesting that Congress intended the Section 2(10) definition to apply in the context of Section 5, not Section 12(2). Weiss, at 14-16.

Finally, it is important to consider Section 12(2) in the context of the 1933 Act as a whole. Buyers assert, but without citation to any authority beyond their "plain meaning" argument, that Section 12(2) "creates an expansive civil remedy for misrepresentations made by [all] sellers of securities." (Resp. Br. at 9)[14] Section 12(2) is more accurately described as complementing Sections 11 and 12(1) by imposing civil liability in public offerings on those who cannot be reached under those liability provisions. Interpreting Section 12(2) as proposed by Sellers will not strip it of meaning or function; rather, it will confine Section 12(2) to its proper and intended sphere.

In sum, the language of Section 12(2), whether viewed in isolation or in the context of all other relevant sections of the Act, indicates that Section 12(2) only creates a remedy in connection with public offerings of securities. Plainly, this reading is supported by a great deal of authoritative legislative history, while no such support exists for Buyers' interpretation of Section 12(2).

C. WELL CONSIDERED – PRECEDENT AGREES THAT SECTION 12(2) ONLY APPLIES TO PUBLIC OFFERINGS

Since *Ballay*, most of the courts considering this issue have concluded that Section 12(2)'s application was

[14] Buyers misleadingly cite *Westinghouse Elec. Co. v. "21" Int'l Holdings, Inc.*, 821 F. Supp. 212 (S.D.N.Y. 1993), as demonstrating that private sales of securities are sometimes registered. The transaction there had to be registered because of the purchaser's intent to resell the stock.

intended to be limited to the public offering context.[15] Buyers, and to lesser extent the SEC, nonetheless attempt to rely on old precedent reflecting an initial and erroneous assumption regarding the language and intent of Section 12(2) which was uncritically adopted by later commentators and courts.

Moore v. Gorman, 75 F. Supp. 453 (S.D.N.Y. 1948), was the first court to analyze whether Section 12(2) applied to exempt transactions. The court begged the essential question when it concluded that Section 12(2) applied even to exempt transactions because Section 4 "does not purport to, nor does it, confer any exemption from the civil liability imposed by Section 12(2)." *Id.* at 456. Of course, that Section 4 does not purport to exempt private offerings from Section 12(2) would be significant *only if* Section 12(2) otherwise applied to exempt transactions.[16] The precedential value of the *Moore* decision is further weakened by the fact that the transaction in *Moore* was probably not exempt and thus should have been registered. *See, e.g., United States v. Wolfson*, 405 F.2d 779 (CA2 1968), *cert. denied*, 394 U.S. 946 (1969).

[15] *See First Union Discount Brokerage Serv., Inc. v. Milos*, 997 F.2d 835 (CA11 1993); *Cheltenham Bank v. Drexel Burnham Lambert, Inc.*, 1989 CCH ¶ 94,391 (E.D.N.C. 1989), *cert. denied*, Fed. Sec. L. Rep. ¶ 94,564 (E.D.N.C. 1989); *Fujisawa Pharmaceutical Co. v. Kapoor*, 814 F. Supp 720, 728 (N.D. Ill. 1993); *Budget Rent A Car Systems, Inc. v. Hirsch*, 810 F. Supp. 1253, 1257 (S.D. Fla. 1992).

[16] "[T]o conclude that Section 12(2) applies to private offerings *because* Section 4 does not exempt such offerings from Section 12(2) makes no more sense than to say that Section 11 applies to private offerings because Section 4 does not exempt such offerings from Section 11." Weiss at 27. No one would dispute that Section 11 applies only to a transaction that involves use of a registration statement and, similarly, no one can dispute that Section 12(2) applies only to a transaction effectuated "by means of a prospectus or oral communication." Whether a privately negotiated sale is such a transaction was the question of first impression before *Moore*. The *Moore* court's failure to address – much less answer – *that* question led it and later courts astray.

Moore was cited by Professor Loss in the first edition of his influential treatise, *Securities Regulation*, 997 (1951) [hereinafter "Loss"] where, without analyzing the nature of the remedy or what the phrase "by means of a prospectus or oral communication" means in Section 12(2) he asserted: "[T]he Section applies to all sales of securities, whether or not registered, whether or not the particular security or transaction is exempted from Section 5". Professor Loss attributed the absence of an express statement that Section 12(2) applied to transactions exempted by Section 4 to "a mere happenstance of drafting." *Id.* n. 201.

Wilko v. Swan, 127 F. Supp. 55, 58 (SDNY 1955) added momentum to this erroneous view when it asserted, without analysis of the language or intended coverage of Section 12(2), that the Section expressly rendered inapplicable the exemptions of sections 3 and 4 of the Act. *Woodward v. Wright*, 266 F.2d 108 (CA10 1959), which held that Section 12(2) applied to a private sale, cited *Wilko* uncritically and asserted, without further analysis, that Sections 12(2) and 17 of the 1933 Act "grant recision or damages for fraud or misrepresentation in the sale of the securities generally."

The later decisions cited by Buyers illustrate the widespread influence of these early misguided authorities. First, *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680, 695 (CA5 1971) assumed as a "preliminary observation" that Sections 3 and 4 do not expressly exempt private transactions from Section 12(2), citing, without analysis, *Woodward*, *Moore* and Loss. Then *Nor-Tex Agencies, Inc. v. Jones*, 482 F.2d 1093, 1099 (CA5 1973), *cert. denied*, 415 U.S. 977 (1974), in *dicta* since public offers were made, cited *Hill* without analysis. Next, *Haralson v. E.F. Hutton Group, Inc.*, 919 F.2d 1014, 1032 (5th Cir. 1990) merely cited *Nor-Tex*. Finally, *Multimedia Co. v. Fugazy*, 983 F.2d 350 (CA2 1992), *cert. denied*, 113 S.Ct. 2445 (1993) relied on *Hill York*, *Nor-Tex* and Loss and did not independently analyze the issue.

As Professor Loss observes in *The Assault on Securities Act Section 12(2)*, 105 Harv. L. Rev. 908 (1992):

> "Every so often a faulty decision by one court is picked up by a second, and then by a few more, until it acquires a life of its own. In the fullness of time, however, a few brave judicial souls see the light . . . and further development is set on the right course."

Until *Ballay* focused attention on the intended coverage of Section 12(2), the notion that it covered all transactions had achieved a "life of its own" not based on any analysis of Section 12(2)'s language or purpose. The Court here can set further development on the right course by approving the reasoning of *Ballay* and other recent cases holding that Section 12(2) does not apply to negotiated private transactions.[17]

CONCLUSION

Making a seller of a security a fiduciary makes no sense whatsoever in a private negotiation context where parties able to fend for themselves are attempting to strike the best deal. Such parties should be able to negotiate risk bearing or sharing without the seller being forced to be the guarantor of the accuracy of all disclosures and the lack of materiality of all omissions. Fraud is what is

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[17] Buyers' references to prior statements by this Court, frequently out of context or in phrases never intended to have the meaning Buyers now ascribe to them, are not persuasive. This Court has never focused on the issue now before it and the pretense of Buyers to the contrary must be rejected. In particular, *Gould v. Ruefenacht*, 471 U.S. 701, 703-704 (1985), while it involved a claim under Section 12(2) relied on the analysis in *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985) which contributed nothing to aid the analysis of Section 12(2) since the Court there held only that the stock involved was a "security" within the meaning of the Securities and Exchange Act of 1934, specifically referencing the lack of exemption in that Act comparable to those in Section 4 of the 1933 Act. Sellers' assertions here as to the meaning of "by means of a prospectus" is in no sense analogous to an argument that a block of stock is not a security within the meaning of the Acts.

actionable in private contexts – not innocent misstatements or omissions. The conclusion of the Court here must be that Congress did not intend, by the Act, to make sellers of securities in negotiated private transactions fiduciaries of the buyers.

Respectfully submitted,

DONALD W. JENKINS*
THOMAS P. DESMOND
JENNIFER R. EVANS

VEDDER, PRICE, KAUFMAN
& KAMMHOLZ
222 North LaSalle Street
Chicago, IL 60601
(312) 609-7500

*Counsel for Petitioner
Arthur L. Gustafson*

*Counsel of Record

HAROLD C. WHEELER*
PETER C. WOODFORD
DEBRA A. WINIARSKI

SEYFARTH, SHAW, FAIRWEATHER
& GERALDSON
55 East Monroe Street
Chicago, IL 60603
(312) 346-8000

*Counsel for Petitioners
Daniel R. McLean and
Francis I. Butler*

*Counsel of Record

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DEC 3 PAGE 1

93-404 (11)

No. 93-201

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1993

ALLEN & COMPANY INCORPORATED,

Petitioner,

v.

PACIFIC DUNLOP HOLDINGS INC.,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

RESPONDENT PACIFIC DUNLOP HOLDINGS INC.'S RESPONSE TO MOTION FOR CONSOLIDATION FILED IN GUSTAFSON V. ALLOYD CO. INC., NO. 93-404

Respondent Pacific Dunlop Holdings Inc. ("Pacific Dunlop"),[1] by its attorneys, Gardner, Carton & Douglas, hereby submits its Response to the Motion For Consolidation filed on November 29, 1993 by the petitioners in Gustafson v. Alloyd Co. Inc. ("Gustafson Petitioners"), No. 93-404.

1. The Gustafson Petitioners cite Supreme Court Rule 27.3 as authority for the proposition that "two or more cases involving the same or related questions may be consolidated upon motion by any party." Gustafson Petitioners' Motion For Consolidation ("Gustafson Motion") at ¶5. The Gustafson Petitioners' citation to Rule 27.3 is misleading. Rule 27.3 states only that "the Court may order that two or more cases involving what appear to be the same or related questions, be argued together as one case or on any other term as may be prescribed." (Emphasis added). Thus, by its terms, Rule 27.3 applies only after the Court has granted the

1 Pursuant to Supreme Court Rule 29.1, Pacific Dunlop included a "List of Parties" in its Brief In Opposition To Petition For A Writ Of Certiorari Of Allen & Company, Inc., filed September 7, 1993.

petitions for certiorari in both of the putative consolidated cases. Rule 27.3 does not authorize consolidation of pending certiorari petitions upon which the Court has not ruled.

2. No other provision of the Supreme Court Rules provides for the consolidation of pending certiorari petitions. Furthermore, the last sentence of Rule 12 provides: "A petition for a writ of certiorari shall not be joined with any other pleading." Although it is not clear whether the phrase "any other pleading" as used in Rule 12 encompasses a separately-filed certiorari petition and thus prohibits the consolidation of two certiorari petitions before either has been ruled upon, Pacific Dunlop respectfully suggests that the Court should consider each separately filed certiorari petition on its own merits. If the Court grants both petitions, if it wishes, it can then consolidate them for argument pursuant to Rule 27.3.

3. Finally, Pacific Dunlop notes that the statement in the Gustafson Petitioners Motion at n. 1 that "Pacific Dunlop involves a broker-seller" is wrong. Allen & Company, Inc., the seller in this case, was a shareholder-seller. See Pacific Dunlop's Brief In Opposition To Allen & Company, Inc.'s Petition For A Writ Of Certiorari at 2.

Respectfully submitted,

PACIFIC DUNLOP HOLDINGS INC.

By: Joe A. Sutherland /MAF
*JOE A. SUTHERLAND
MICHAEL J. KOENIGSKNECHT
PETER J. MEYER
DEENA S. NEWLANDER

*COUNSEL OF RECORD

GARDNER, CARTON & DOUGLAS
321 N. CLARK STREET, SUITE 3400
CHICAGO, ILLINOIS 60610
(312) 644-3000

ATTORNEYS FOR RESPONDENT
PACIFIC DUNLOP HOLDINGS INC.

Dated: December 2, 1993

(12)

No. 93-404

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1993

ARTHUR L. GUSTAFSON,
DANIEL R. McLEAN and
FRANCIS I. BUTLER,

Petitioners,

v.

ALLOYD CO., INC., a Delaware corporation,
f/k/a ALLOYD HOLDINGS, INC., and WIND POINT
PARTNERS II, L.P., a Delaware limited partnership,

Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

RESPONDENTS OPPOSITION TO
PETITIONERS' MOTION FOR CONSOLIDATION

Respondents Alloyd Co., Inc. and Wind Point Partners II, L.P. oppose Petitioners' Motion for Consolidation.[1] In opposition to Petitioners' motion, Respondents state as follows:[2]

[1] Pursuant to Supreme Court Rule 29.1, Respondents included the required list of parties in their Brief in Opposition to the Petition for Writ of Certiorari.

[2] Respondents received a copy of Petitioners' Motion to Consolidate on November 29, 1993. Pursuant to Supreme Court Rule 21, Respondents' response is due within ten days (December 9, 1993).

4 pp

1. **Petitioners' motion for consolidation is premature and should be denied. This Court has not granted certiorari in either this case or Allen & Co. Inc. v. Pacific Dunlop Holdings, Inc., No. 93-201. Unless and until certiorari is granted in both cases, consolidation is inappropriate. Supreme Court Rule 27.3, relied upon by Petitioners as authority for their motion to consolidate, pertains only to consolidation of oral argument; that rule has no application here. For a more detailed analysis of the lack of authority for consolidating pending certiorari petitions, Respondents respectfully refer the Court to the Response of Pacific Dunlop Holdings Inc. ¶¶ 1-2.**

2. **Moreover, as Respondents explained in their brief in opposition to the Petition for a Writ of Certiorari (Brief in Opposition at 6), this case stands in a much different procedural posture than Allen & Co. The District Court is currently considering fully briefed motions for summary judgment in this case on issues separate from those raised in the Petition for Certiorari. As a result, this case is not ripe for review by this Court. Given the interlocutory nature of this case, Respondents respectfully suggest that it would be inappropriate to consolidate this case with Allen & Co. at this time.**

WHEREFORE, Respondents request that this Court deny Petitioners' Motion to Consolidate.

DATED: December 9, 1993

Respectfully submitted,

Robert J. Kopecky
(Counsel of Record)
Brian D. Sieve
Carole A. Cheney
KIRKLAND & ELLIS
200 East Randolph Drive
Chicago, Illinois 60601
(312) 861-2000
Firm No. 90443

Counsel for Respondents Alloyd Co., f/k/a Alloyd Holdings, Inc., and Wind Point Partners, II, L.P.

WPPD41.BDS

CERTIFICATE OF SERVICE

I, Robert J. Kopecky, an attorney, hereby certify that I caused a copy of the foregoing Respondents' Opposition to Petitioners' Motion for Consolidation, to be served via United States mail, first-class postage prepaid, this 9th day of December, 1993 upon:

Gerald D. Skoning
Harold C. Wheeler
Peter C. Woodford
Debra A. Winiarski
Seyfarth, Shaw, Fairweather & Geraldson
55 East Monroe Street
Suite 4200
Chicago, IL 60603

Donald W. Jenkins
Thomas P. Desmond
Andrew M. Gardner
Michael L. Kayman
Vedder, Price, Kaufman & Kammholz
222 North LaSalle Street
Suite 2600
Chicago, Illinois 60601

Robert J. Kopecky

MOTION FILED
NOV 30 1993

No. 93-404

In The

SUPREME COURT OF THE UNITED STATES

October Term 1993

Arthur L. Gustafson, Daniel R. McLean
and Francis I. Butler

Petitioners.

v.

Alloyd Co., Inc. and Wind Point Partners II, L.P.

Respondents.

On Petition for Writ of Certiorari to the United
States Court of Appeals for the Seventh Circuit

PETITIONERS' MOTION FOR CONSOLIDATION

NOW COMES the Petitioners, Arthur L. Gustafson ("Gustafson"), Daniel R. McLean ("McLean") and Francis I. Butler ("Butler"), pursuant to Supreme Court Rule 27.3, and move this Court to consolidate this case with Allen & Company Inc. v. Pacific Dunlop Holdings, Inc., No. 93-201.

1. On September 9, 1993, Gustafson, McLean and Butler filed a petition for writ of certiorari to the United States Court of Appeals for the Seventh Circuit. In this case, Respondents claim that material misrepresentations were made in connection with Petitioners' privately negotiated resale of substantially all of the common stock of Alloyd Co., Inc. in violation of Section 12(2) of the Securities Act of 1933 and in breach of the stock purchase agreement. The judgment of the district court in this case was

vacated and remanded by the Seventh Circuit for "further proceedings in light of this court's opinion in Pacific Dunlop Holdings, Inc. v. Allen & Co., Inc., No. 91-2346 (7th Cir. May 7, 1993)."

2. The potential application of Section 12(2) of the Securities Act of 1933, 15 U.S.C. §771(2), to a privately negotiated secondary market transaction is a substantial, recurring legal question. A direct conflict exists among the circuit courts, and there is wholesale disarray in the district courts and among legal scholars, regarding the question presented. Compare Pacific Dunlop Holdings Inc. v. Allen & Co., Inc., 993 F.2d 578 (7th Cir. 1993) with Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d 682 (3d Cir.), cert. denied 112 U.S. 79 (1991) and First Union Discount Brokerage Services, Inc. v. Milos, 997 F.2d 835 (11th Cir. 1993) (Respondents' Brief in Opposition recognizes Milos creates further direct conflict among the circuits). See also Petition at 10-12. Substantial statutory construction and policy issues are also raised by the question presented in interpreting the language and legislative history of Section 12(2) and the structure and purpose of the 1933 Act.

3. As noted in the Petition for Certiorari herein, on August 24, 1993, Allen & Company Inc. filed a petition for a writ of certiorari to the United States Court of Appeals for the Seventh Circuit in Pacific Dunlop Holdings Inc. v. Allen & Co. Inc., 993 F.2d 578 (7th Cir. 1993), petition for cert. filed, 62 U.S.L.W. 3144 (Aug. 24, 1993) (No. 93-201). The question presented therein

is whether Section 12(2) of the Securities Act of 1933, 15 U.S.C. §771(2), provides a valid cause of action in a secondary market securities transaction and/or in a privately negotiated resale of securities. The Seventh Circuit's decision in Pacific Dunlop has a direct and controlling effect on the remand of this case from the appellate court to the trial court.

4. On October 4, 1993, the Court, recognizing the significance of the question presented, invited the Solicitor General to file briefs expressing the views of the United States in the Pacific Dunlop case. Allen & Company Inc. v. Pacific Dunlop Holdings, 114 S.Ct. 52 (62 U.S.L.W. 3242) (Oct. 4, 1993) (No. 93-201). A decision on the petition for writ of certiorari in that case will not be forthcoming until the government has set forth its views and concerns.

5. Pursuant to Supreme Court Rule 27.3, two or more cases involving the same or related questions, may be consolidated upon motion by any party. The facts and circumstances involved in this case and Pacific Dunlop are substantially similar. Both cases involve the secondary market sale of substantially all of the outstanding stock of an entity by means of a privately negotiated stock purchase agreement, and involve an alleged financial misstatement significantly affecting net income. Both actions also set forth causes of action based only on Section 12(2) and state law breach of contract without any allegation of intentional fraud under Section 10(b) of the Securities Exchange Act of 1934 or SEC

Rule 10b-5 promulgated thereunder, and were decided on summary judgment.

6. Pacific Dunlop sets forth a two part question presented:

> Whether application of Section 12(2) of the 1933 Act is limited to initial distributions of securities?
>
> Does Section 12(2) of the 1933 Act apply to a privately negotiated resale of securities that does not involve the distribution of stock to the public?

Petitioners have asked the Court to decide:

> Whether Section 12(2) of the Securities Act of 1933 is applicable to a privately negotiated resale of all of the stock of a corporation.

The question presented by Petitioners is the same as and succinctly encompasses the questions set forth in Allen & Co. Inc. v. Pacific Dunlop Holdings, No. 93-201.[1]

7. This case is currently pending before the district court awaiting final adjudication, either by summary judgment or at trial, of the Section 12(2) claim (which provides the only basis for federal jurisdiction). Unless the case is consolidated with Pacific Dunlop, that adjudication will have to be made without the guidance of this Court. Thus, the inconsistency existing among the circuits may be compounded by further inconsistencies among district courts in the Seventh Circuit, and between those courts and this Court.

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[1] Although Pacific Dunlop involves a broker-seller and Gustafson involves shareholder-sellers, the questions presented are virtually identical and both focus on the primary issue of whether Section 12(2) applies to any secondary market transaction or private resale of securities regardless of the type of seller.

As a result of the substantial similarity in questions presented, underlying facts, district court holdings, and the direct impact of the Seventh Circuit's decision in Pacific Dunlop on the resolution of this case, Petitioners respectfully request this Court consolidate this case and Allen & Company Inc. v. Pacific Dunlop Holdings, Inc., No. 93-201.

Respectfully submitted,

By: [signature]

Gerald D. Skoning*
Harold C. Wheeler
Peter C. Woodford
Debra A. Winiarski
Seyfarth, Shaw, Fairweather & Geraldson
55 East Monroe Street
Suite 4200
Chicago, Illinois 60603
(312) 346-8000

Counsel for Petitioners

Daniel R. McLean and
Francis I. Butler

By: Andrew M. Gardner

Donald W. Jenkins
Thomas P. Desmond
Andrew M. Gardner*
Michael L. Kayman
Vedder, Price, Kaufman & Kammholz
222 North LaSalle Street
Suite 2600
Chicago, Illinois 60601
(312) 609-7500

Counsel for Petitioner

Arthur L. Gustafson

Dated: November 29, 1993

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* Counsel of Record

No. 93-404

In The

Supreme Court of the United States

October Term, 1994

ARTHUR L. GUSTAFSON, DANIEL R. McLEAN
and FRANCIS I. BUTLER,

Petitioners,

v.

ALLOYD CO., INC. and
WIND POINT PARTNERS II, L.P.,

Respondents.

**On Writ Of Certiorari
To The United States Court Of Appeals
For The Seventh Circuit**

SUPPLEMENTAL BRIEF OF RESPONDENTS ALLOYD CO., INC. AND WIND POINT PARTNERS II, L.P.

ROBERT J. KOPECKY*
BRIAN D. SIEVE
CAROLE A. CHENEY
JONATHAN F. PUTNAM
KIRKLAND & ELLIS
200 East Randolph Drive
Chicago, Illinois 60601
(312) 861-2000

KENNETH W. STARR
PAUL T. CAPPUCCIO
KIRKLAND & ELLIS
655 Fifteenth Street, N.W.
Washington, D.C. 20005
(202) 879-5000

Counsel for Respondents

October 11, 1994 *Counsel of Record

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

SUPPLEMENTAL QUESTION PRESENTED

Does section 12(2) of the Securities Act of 1933 apply to secondary transactions as well as initial offerings of securities?

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SUMMARY OF ARGUMENT

Section 12(2) does not expressly limit its civil remedy to "initial offerings" of securities, which are commonly understood to be sales by issuers. The term "prospectus," as used in section 12(2), is defined broadly and is not limited to statements made in connection with initial offerings. The other key provisions of the Act, sections 5, 11, 12(1) and 17, all apply, in varying degrees, to secondary offerings. The legislative history contains no unambiguous evidence of a legislative intent to restrict the civil remedy provided by section 12(2) to initial offerings. Moreover, one of the principal remedial purposes of the Act would be thwarted by excluding secondary sales from the scope of section 12(2), and there is no strong countervailing policy reason for construing the section narrowly. Finally, even if section 12(2) were construed as applying to less than the full array of secondary transactions, it should apply to sales by controlling shareholders of the issuer, such as the sale by petitioners in this case.

ARGUMENT

I. The Language And Structure Of The Statute Demonstrate That Section 12(2) Applies To Both Initial And Secondary Sales Of Securities.

The 1933 Act neither defines nor employs the terms "initial" offering or "secondary" sale. As reflected in the *amicus* briefs of the Solicitor General and the Securities Industry Association ("SIA"), however, these terms have well-settled meanings. An "initial offering" is generally understood to be a sale of securities by the issuer, while a "secondary" sale is a subsequent transaction by any other person or entity.[1] (*See* SEC Br. 5-6 n.5; SIA Br. 2 n.2) The

[1] *Black's Law Dictionary* contains similar definitions of the two categories of offerings. "Securities offerings are generally of two types: primary (proceeds going to the company for some lawful purpose) and secondary (where the funds go to a person other than the company; *i.e.*, selling stockholders)." *Black's Law Dictionary* 1082 (6th ed. 1990).

absence of these or any similar terms from the Act indicates that Congress did not intend to draw any distinction between initial and secondary securities transactions. As discussed below, neither the text nor the structure of the Act supports limiting section 12(2) to the narrow category of initial offerings.

A. The Text Of The Statute Does Not Limit Section 12(2) To Initial Offerings.

The text of section 12(2) squarely contradicts the argument that the civil remedy applies only to initial offerings of securities – that is, offerings *by issuers*. Congress defined the term "issuer" in the 1933 Act, *see* 15 U.S.C. § 77b(4), and used the term repeatedly throughout the Act in specifying the obligations, exemptions and remedies under the Act. *See, e.g., id.* §§ 77c(a)(1), 77d(1), 77d(6), 77k(b). Section 12(2), however, contains no language limiting its application to sales by "issuers." To the contrary, section 12(2) provides a civil remedy against "*[a]ny person*" who offers or sells a security through a misleading prospectus or oral statement. *Id.* § 77l (emphasis added).

The breadth of section 12(2) is confirmed by section 2(3), which defines "sale" and "sell" broadly to include "*every* contract of sale or disposition of a security." *Id.* § 77b(3) (emphasis added). And this Court held in *Gould v. Ruefenacht*, 471 U.S. 701 (1985), that the "securities" covered by section 12(2) include those sold in a privately-negotiated resale of a corporation's stock. Thus, the operative transactional terms in section 12(2) encompass both initial and secondary sales of securities.

The leading decision limiting section 12(2) to initial offerings, *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682 (3d Cir.), *cert. denied*, 112 S. Ct. 79 (1991), ignores these broad, all-inclusive terms. The court in *Ballay* instead focused exclusively on the phrase "by means of a prospectus

or oral communication," which it read as limiting section 12(2) to "the sale of a security in an initial distribution." *Id.* at 688. The court concluded that "the plain meaning of the words 'prospectus or oral communication' together is that buyers may recover for material misrepresentations made in a prospectus or in an oral communication related to a prospectus or initial offering." *Id.* The court did not explain how the "plain meaning" of the various terms used by Congress in the definition of "prospectus" supports limiting section 12(2) to initial offerings.[2]

The terms used in defining "prospectus" include any "notice, circular, advertisement, letter, or communication" offering a security for sale. 15 U.S.C. § 77b(10). Neither these terms nor the term "oral communication" connotes a limitation to offerings by issuers, as opposed to sales by other owners of securities. As the court noted in *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 582, 588 (7th Cir. 1993), section 2(10) defines prospectus "very broadly," and the key determinant of a prospectus is "whether the substance of the words used offers to sell or confirm[s] the sale of a security."

Nor does the use of the term "prospectus" in section 10 of the Act, 15 U.S.C. § 77j, support limiting section 12(2) to initial offerings, as asserted by the court in *Ballay*. 925 F.2d at 688-89. Section 10 sets forth the information required in a particular kind of prospectus – one issued in conjunction with a registration statement. The SEC has long recognized the distinction between a "formal prospectus" meeting the criteria of section 10 and the broader category of prospectus defined in section 2(10). SEC Release No. 33-2623, 11 Fed. Reg.

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[2] The Eleventh Circuit's decision in *First Union Discount Brokerage Services, Inc. v. Milos*, 997 F.2d 835 (11th Cir. 1993), adds nothing to the analysis of this issue. First, the court in *First Union* did no independent analysis of the initial/secondary issue, but rather adopted the *Ballay* court's analysis. Second, the case did not involve any secondary sale to Milos "by means of a prospectus or oral communication" containing misrepresentations about any securities. Rather, the case involved a liquidation of Milos's margin account by his discount broker, and the section 12(2) claim was therefore apparently not based on any purchase of securities by him. *Id.* at 840.

10964 (July 25, 1941); *see* Resp. Br. 23 n.17; SEC Br. 10-11. Nothing in the text of section 12(2), or elsewhere in the Act, indicates Congress intended to limit "prospectus" as used in section 12(2) to the "formal" section 10 prospectus.[3]

In sum, the text of section 12(2) simply cannot be read as limiting its civil remedy to sales by issuers or sales of newly issued shares. The only word in section 12(2) relied upon by advocates for limiting the section to initial offerings – "prospectus" – cannot support such a limitation because Congress defined the term using words that are not limited to the context of initial offerings. (*See* Resp. Br. 20-24) To read section 12(2) as limited to initial offerings would require ignoring the words Congress used, as well as those it elected not to use, in drafting the provision.

B. The Structure Of The 1933 Act Confirms That Section 12(2) Is Not Limited To Initial Offerings.

The other provisions of the 1933 Act confirm that section 12(2) is not limited to initial offerings. Contrary to the opinion in *Ballay*, 925 F.2d at 691, the registration requirement of section 5 and the remedial provisions of sections 11 and 12(1) all apply to secondary transactions as well as initial offerings.

Section 5 provides that, "[u]nless a registration statement is in effect as to a security, it shall be unlawful for any person" to sell such security "through the use or medium of any prospectus or otherwise." 15 U.S.C. § 77e(a)(1). While section 4(1) of the Act exempts from registration "transactions by any person other than an issuer, underwriter, or dealer," a broad range of secondary sales remain subject to the registration requirement. For example, if a shareholder of a corporation decides to sell his shares through an underwriter, registration is required under section 5 because sales by

[3] In *Pacific Dunlop*, the Seventh Circuit also thoroughly analyzed whether the "context" of the Act requires a different definition of prospectus in section 12(2) than that contained in section 2(10). 993 F.2d at 584-88. After examining the structure and text of the Act, the court concluded that nothing in the statutory context requires a definition of prospectus in section 12(2) "contrary to the broad definition of section 2(10)." 993 F.2d at 588.

an underwriter are not exempted under section 4. *See, e.g.*, C. Johnson, *Corporate Finance and the Securities Laws* 10 (1990). Similarly, a "control person" who sells "restricted securities," except under the narrow circumstances prescribed in SEC Rule 144, will be deemed to be engaged in a "distribution" and thus required to register his or her shares.[4] *Id.* at 14; *see* 3 L. Loss & J. Seligman, *Securities Regulation* 1507 (3d ed. 1989).

Section 12(1) provides a civil remedy against "[a]ny person" who "offers or sells a security in violation of section 77e." 15 U.S.C. § 77l(1). Thus, any secondary offering that must be registered under section 5, if consummated without a registration statement, will subject the seller to the civil remedy in section 12(1).

Section 11, which provides civil remedies for material misrepresentations or omissions in any registration statement, similarly extends beyond initial offerings. A purchaser of securities has a remedy under section 11 for misrepresentations in a registration statement for a secondary offering of restricted securities by a control person or a secondary distribution through an underwriter. Moreover, section 11 contains no privity requirement; it creates a right of action for any person who acquires securities covered by a false or misleading registration statement. 15 U.S.C. § 77k(a). Section 11 therefore provides a civil remedy not only for those persons who purchased directly on the offering, but also for those who subsequently purchase in the after-market and can trace the particular shares they purchase to the registration statement. *See, e.g.*, *Klein v. Computer Devices, Inc.*, 591 F. Supp. 270, 273 n.7 (S.D.N.Y. 1984); 9 L. Loss & J. Seligman, *Securities Regulation* 4267 (3d ed. 1992).

Thus, both *Ballay* and *amicus* SIA are wrong in asserting that section 12(2) must be limited to initial offerings in order to be consistent with sections 11 and 12(1). Even if section 12(2) were read in the narrowest possible way as co-extensive

[4] As defined in Rule 144, "restricted securities" include those acquired directly or indirectly from an issuer or its affiliates in any transaction not involving a public offering. 17 C.F.R. § 230.144(3).

with sections 11 and 12(1), it still would apply to numerous secondary transactions.

Furthermore, as explained more fully in Buyers' principal brief, section 12(2) is *not* limited to those transactions covered by sections 11 and 12(1). For example, section 3 exempts various types of securities from the registration requirements of the Act, but section 12(2) expressly states that sales of such securities are not exempt from the civil remedies for misrepresentation. Similarly, section 4 exempts certain transactions from the registration requirement, but the exemption is limited by its terms to section 5. *See* 9 L. Loss & J. Seligman, *Securities Regulation* 4198 (3d ed. 1992) (section 12(2) "applies to all sales of securities, whether or not registered and whether or not the particular security or transaction is exempted from § 5").

Finally, it is well settled that the criminal anti-fraud provision in section 17 of the Act is not limited to initial offerings. As this Court stated in *United States v. Naftalin*, 441 U.S. 768, 777-78 (1979), section 17 "was intended to cover any fraudulent scheme in an offer or sale of securities, whether in the course of an initial distribution or in the course of ordinary market trading." Since section 12(2) similarly addresses misrepresentations in connection with sales of securities, it should also be applied to secondary sales.

II. The Legislative History Of The 1933 Act Does Not Support Construing Section 12(2) As Limited To Initial Offerings.

The language of a statute is presumed to express the intent of Congress. *See Ardestani v. INS*, 112 S. Ct. 515, 520 (1991). Where, as here, the scope of a statute can be determined by analyzing its language and structure, only the clearest legislative history would justify reaching a different result. *See, e.g., National Organization for Women, Inc. v. Scheidler*, 114 S. Ct. 798, 806 (1994). No such clear legislative intent exists in this case.

This Court has previously observed that the legislative history of section 12(2) is "sparse," *Randall v. Loftsgaarden*, 478 U.S. 647, 657 (1986), and even an ardent advocate for construing section 12(2) narrowly has acknowledged that the provision "was never separately analyzed and was only occasionally mentioned in the legislative history." Prentice, *Section 12(2): A Remedy for Wrongs in the Secondary Market?*, 55 Albany L. Rev. 97, 107 (1991). Nothing in the House Report (H.R. Rep. No. 85), the Senate Report (S. Rep. No. 875), or the Conference Report (H.R. Conf. Rep. No. 152) states that section 12(2) is limited to initial offerings. Nor is there any statement in the legislative history that Congress intended the word "prospectus" to limit section 12(2) to initial offerings. At bottom, the legislative history is simply silent on this point.[5]

Unable to cite anything in the legislative history specifically supporting a constricted reading of section 12(2), both Sellers and SIA rely on general statements by Members of Congress, as well as snippets from the House Report, indicating that the primary focus of the Act was initial offerings. (*See, e.g.*, Pet. Br. 23 n.8, 34-36; SIA Br. 14-16) While Buyers concede that statements in the House Report, as well as comments by several members of Congress, suggest the principal focus of the Act was initial offerings, that view was not universal. There was certainly no consensus for the proposition that the Act excludes secondary sales from the civil remedies for misrepresentation. Some Members of Congress, as well as leading commentators, expressed the contemporaneous view that the 1933 Act covers both initial and secondary offerings.

During debates on the Securities Exchange Act in May 1934, for example, Senator Kean provided a detailed

[5] Of course, one cannot infer from this silence that Congress intended to exclude secondary transactions from the scope of section 12(2). *See Landreth Timber Co. v. Landreth*, 471 U.S. 681, 696 n.7 (1985). As the Court explained in *Landreth*, the courts and the SEC have applied the 1933 and 1934 Acts to a variety of transactions as to which the legislative history is silent. *Id.*

comparison of the 1933 Act with the British Companies Act of 1929.[6] 78 Cong. Rec. 8666, 8674-8696 (May 12, 1934). That comparison explained that "[t]he United States act covers original *and subsequent transactions* in securities; the British act deals chiefly with the original offer of securities to the public and not to subsequent transactions in those securities." *Id.* at 8674 (emphasis added); *see also id.* at 8676 ("United States act applies (disregarding the exceptions) to all transactions in all securities"). Similarly, during the House debates on an early version of the Exchange Act (H.R. 9323), Congressman Mapes explained that the 1933 Act "was based upon the theory that *anyone* who made a false representation to an innocent investor should reimburse the innocent investor whatever he suffered because of that false representation." 78 Cong. Rec. 8105 (emphasis added).

The individuals principally involved in drafting the 1933 Act also expressed the contemporaneous view that section 12(2) applies to secondary transactions. For example, Arthur Dean, who consulted with the House Commerce Committee during the drafting process, and then-professor Felix Frankfurter, the head of the team that drafted the Act, both wrote in 1933 that section 12(2) applies to secondary transactions. *See* Dean, *The Federal Securities Act: I*, 8 Fortune 50, 102 (1933); Frankfurter, *The Federal Securities Act: II*, 8 Fortune 53, 108 (1933). As explained in Buyers' principal brief, that view was echoed even by early critics of the Act. (*See* Resp. Br. 46-47) And with few exceptions, leading commentators, including Professor Loss, have consistently said that section 12(2) is not limited to initial distributions. (*Id.* at 47 n.36)

In sum, nothing in legislative history of section 12(2) expressly reflects a legislative intent to limit the civil remedy in that section to initial offerings. Collectively, comments by individual Members of Congress regarding the scope of the

[6] This Court has noted previously that the British Companies Act was the "statutory antecedent" of the federal securities laws. *SEC v. Ralston Purina Co.*, 346 U.S. 119, 123 (1953).

Act are, at best, ambiguous. Accordingly, the legislative history does not justify departing from the plain language of the statute.

III. Limiting Section 12(2) To Initial Offerings Is Inconsistent With The Remedial Purpose Of The Act And Is Not Required By Any Compelling Policy Concerns.

Application of section 12(2) to secondary sales of securities furthers the purposes of the Act by addressing one of the principal goals Congress sought to achieve. In holding that the term "seller" should be construed broadly for purposes of section 12(1), this Court explained in *Pinter* that such a construction "furthers the purposes of the Securities Act – to promote full *and fair* disclosure of information to the public in the sales of securities." *Pinter v. Dahl*, 486 U.S. 622, 646 (1988) (emphasis added). The Court did not suggest that this remedial purpose was limited to initial offerings. To the contrary, misrepresentations can occur just as readily – and are just as invidious – in secondary sales of securities. There is no sound basis in the policy underlying the Act to construe section 12(2) as limited to initial offerings.[7]

A number of examples illustrates this point. If a controlling shareholder of a corporation decided that the corporation should issue new shares of stock and sold them in a registered offering, this "initial offering" would clearly come within section 12(2). If the same shareholder decided instead to resell a portion of his holdings, and did so through an underwriter in a public offering, this "secondary sale" would not be covered by section 12(2) under a construction limited to initial offerings. Similarly, if this controlling shareholder sold his shares in a private placement, the buyers would have no

[7] This policy analysis informed the early decisions holding that section 12(2) applies to both initial and secondary offerings. *See, e.g.*, *Wilko v Swan*, 127 F. Supp. 55, 59 (S.D.N.Y. 1955) (noting that limiting section 12(2) to initial distributions "would frustrate the remedial purposes of the statute and lead to absurd and wholly incongruous results").

claim under section 12(2) even if the sale occurred by means of an offering circular that was identical, word-for-word, to the prospectus used in connection with an initial offering by the corporation. This result cannot be squared with the remedial purpose of the statute. There is no sound reason for giving buyers a remedy for misrepresentations contained in the written materials used by the issuer to sell stock, but not for the same misrepresentations made by the corporation's controlling shareholders in a secondary sale.

SIA urges that section 12(2) must be limited to initial offerings by issuers because broader application would have a devastating impact on dissemination of research reports prepared by securities analysts. (SIA Br. 18-24) The concerns raised by SIA are ill-founded and do not justify a reading of section 12(2) at odds with the text and structure of the Act. SIA's argument rests on a faulty premise – that the construction of section 12(2) adopted by the Seventh Circuit in *Pacific Dunlop* will result in open-ended liability for firms that prepare research reports on publicly-traded securities. There are at least two formidable statutory barriers to a potential suit based on an analyst's research report, both of which belie the calamitous result predicted by the SIA.

First, SIA misreads *Pacific Dunlop* as holding that a "prospectus" for purposes of section 12(2) includes "*any* document connected with the sale of a security." (SIA Br. 8, emphasis added) As *Pacific Dunlop* recognized, section 2(10) defines "prospectus" as a communication that "offers any security for sale or confirms the sale of any security." 15 U.S.C. § 77b(10). Research reports generally do not offer securities for sale.[8] Thus, a research report, even if riddled with factual errors, would not give rise to a claim under

[8] Analysts' reports invariably contain a legend stating that the report "is not an offer to buy or sell or a solicitation of an offer to buy or sell" the securities. The SEC has also addressed this issue under its rule-making power. Rule 139 prescribes the circumstances in which a research report on securities of an issuer will not be deemed an "offer to sell" the securities, and thus will not constitute a "prospectus" under section 2(10), even though the firm issuing the report is involved in a distribution of such securities. 17 C.F.R. § 230.139.

section 12(2) because it does not come within the definition of "prospectus."

Second, a plaintiff seeking to assert a claim against the firm that publishes a research report would have to establish that the firm is a "seller" subject to section 12(2). This Court has never addressed the scope of a statutory seller for purposes of section 12(2), although in *Pinter* it did construe the term as used in section 12(1). 486 U.S. at 641-54. In *Pinter*, the Court held that a statutory seller is one who either passes title to the securities or "successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner." *Id.* at 647.

Assuming that this same definition applies to section 12(2), the publisher of a research report could be liable only if it was found to have "successfully solicited" the sale of the securities at issue. A growing body of case law supports the proposition that a "soliciting seller" must have some direct or personal contact with the purchaser. *See* Fisher, *Parsing* Pinter *Four Years Later: Defining a Statutory Seller Under Section 12 of the Securities Act*, 21 Sec. Reg. L.J. 46, 58 & n.41 (1993) (citing cases). It is not at all clear that a firm publishing a research report could be liable under section 12(2) unless it also used that report in personally and actively soliciting a customer to purchase the securities covered by the report.[9]

Finally, construing section 12(2) to apply only to some, but not all, secondary transactions necessarily involves writing into the statute a limitation that is not there. This kind of legislative line-drawing, which entails careful balancing of

[9] SIA also argues that securities analysts would be required "to investigate every conceivable fact regarding a company" if they are subject to section 12(2) liability. (SIA Br. 23) This is again an overblown concern since section 12(2) does not impose liability for pure omissions. Section 12(2) creates liability only for affirmative misstatements by a seller or for omission of facts that make the seller's statements misleading. There is no sound policy reason why a broker who negligently makes a misstatement of fact to a purchaser of securities should escape liability simply because the transaction was a secondary sale rather than an initial offering.

the various interests to be served by the statute, is uniquely the function of Congress.

IV. The Transaction In This Case Had The Characteristics Of An Offering By The Issuer.

To decide this case, the Court need not decide the extent to which section 12(2) applies to all the participants involved in typical sales of securities on organized securities exchanges. Nor must the Court decide whether, and under what circumstances, section 12(2) applies to analysts' research reports and similar materials published by those engaged in the securities business. These issues are not presented by the facts of this case and their resolution is not essential to the decision here.

The only "initial/secondary" issue presented by this case is whether a sale of a corporation's securities through oral and written representations made by those in control of the corporation is a transaction covered by section 12(2). Even the legislative history frequently cited in support of a narrow reading of section 12(2) confirms that Congress intended the Act to apply to secondary transactions having the basic attributes of an "initial offering." The House Report on an earlier version of the Act explained that, as then drafted, the bill "does not affect the ordinary redistribution of securities *unless such redistribution takes on the characteristics of a new offering by reason of the control of the issuer possessed by those responsible for the offering*." H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933) (emphasis added).

The sale of Sellers' stock in this case had the key characteristics of an "initial offering." The Alloyd board of directors passed a resolution directing that "*the Company* actively solicit bids for the purchase of all of the outstanding stock of the Company." (R. 56, Dep. Ex. 3 at 1; emphasis added) An investment banker was retained "on behalf of the Company and its shareholders" to solicit offers. (*Id.*) That firm prepared and circulated to potential purchasers a "Profile" that was designed to, and did, generate offers for Sellers' stock. (R.

56, Dep. Exs. 2 and 5; McLean Dep. 132; Gustafson Dep. 72-73)

Sellers owned 100% of the stock of Alloyd, held the three most senior management positions in the company, and comprised a majority of the board of directors. All of the key financial information provided to Buyers came from Sellers or their agents. In these circumstances, Sellers were for all practical purposes indistinguishable from the issuer of the stock of Alloyd. Accordingly, section 12(2) should apply to *this* transaction even if the Court concludes that the section does not apply to all secondary market transactions.[10]

The reasoning of the Third Circuit in *Ballay* supports this result. The *Ballay* court concluded there was "good reason" to provide a rescissionary remedy in connection with initial offerings because "sellers receive the full purchase price from the investors and are the investors' sole source of information concerning the value of the security." 925 F.2d at 693. The court contrasted this situation with "sellers in the aftermarket, such as [brokers], who receive only a commission and who are not the investors' sole source of information concerning the value of the stock." *Id.* Here, unlike the transaction in *Ballay*, the proceeds of the sale went to Sellers, and Sellers were Buyers' primary source of information concerning Alloyd.

Similarly, the *Ballay* court reasoned that the rescissionary remedy under section 12(2) was appropriate in the context of initial offerings because misrepresentations in such offerings "can influence the purchase price of securities." *Id.* Under these circumstances, the court explained, "rescissionary damages are appropriate to make an investor whole and deter any negligence on the part of a seller of batch offerings." *Id.* The court found such a remedy inappropriate where misrepresentation by a broker in the secondary market "is less

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[10] The district court, ignoring these undisputed facts, found that Buyers had failed to provide evidence that the transaction in this case "possesses the characteristics of a new offering." (J.A. 20-21) In reaching this conclusion, the court erroneously relied on the irrelevant fact that Alloyd was formed some 30 years before Sellers' disposition of their shares. (J.A. 21)

likely to affect the price of a security and so should not be so heavily penalized." *Id.* Here, once again, the transaction falls within the category for which *Ballay* found application of section 12(2) warranted because the information provided by Sellers was the key determinant of the price paid by Buyers for the Alloyd stock. (*See, e.g.*, R. 56, Kracum Dep. 55-56)[11]

CONCLUSION

For the reasons stated above, section 12(2) is not limited to initial offerings of securities, and the judgment of the court of appeals should be affirmed.

Respectfully submitted,

ROBERT J. KOPECKY*
BRIAN D. SIEVE
CAROLE A. CHENEY
JONATHAN F. PUTNAM
KIRKLAND & ELLIS
200 East Randolph Drive
Chicago, Illinois 60601
(312) 861-2000

KENNETH W. STARR
PAUL T. CAPPUCCIO
KIRKLAND & ELLIS
655 Fifteenth Street, N.W.
Washington, D.C. 20005
(202) 879-5000

Counsel for Respondents

October 11, 1994 — *Counsel of Record

[11] Respondent Wind Point calculated the purchase price based on a multiple of 7.5 times Alloyd's earnings before interest and taxes. (R. 56, Kracum Dep. 112, 115-16) This earnings figure, in turn, was based directly on the interim financial information provided by Sellers, which is the basis for Buyers' misrepresentation claim.

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No. 93-404

In The

Supreme Court of the United States

October Term, 1994

ARTHUR L. GUSTAFSON, DANIEL R. McLEAN and FRANCIS I. BUTLER,

Petitioners,

v.

ALLOYD CO., INC. and WIND POINT PARTNERS II, L.P.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

SUPPLEMENTAL BRIEF

Donald W. Jenkins*
Thomas P. Desmond
Jennifer R. Evans

Vedder, Price, Kaufman & Kammholz
222 North LaSalle Street
Chicago, IL 60601
(312) 609-7500

Counsel for Petitioner Arthur L. Gustafson

*Counsel of Record

Harold C. Wheeler*
Peter C. Woodford
Debra A. Winiarski

Seyfarth, Shaw, Fairweather & Geraldson
55 East Monroe Street
Chicago, IL 60603
(312) 346-8000

Counsel for Petitioners Daniel R. McLean and Francis I. Butler

*Counsel of Record

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

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INTRODUCTION

The Court has requested supplemental briefs as to whether Section 12(2) of the Securities Act of 1933 (the "Act") is applicable to secondary transactions as well as initial offerings. If so, the Section represents a broad departure from the otherwise limited scope of the Act. As demonstrated in prior briefs and below, consistent with the Act's other provisions, Section 12(2) applies to initial offerings, not secondary transactions. *Ballay v. Legg Mason Wood Walker*, 925 F.2d 682 (CA3), *cert. denied*, 112 U.S. 79 (1991); *First Union Discount Brokerage Services, Inc. v. Milos*, 997 F.2d 835 (CA11 1993). *See generally*, E. Weiss, *The Courts Have it Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 Bus. Law. 1 (1992) ("Weiss"); R. Prentice, *Section 12(2): A Remedy for Wrongs in the Secondary Market?*, 55 Alb. L. Rev. 97 (1991) ("Prentice"). Most clearly, Section 12(2) does not apply to the particular type of secondary transaction at issue here, a negotiated private secondary sale to sophisticated investors. This is demonstrated by the Act's almost exclusive focus on regulating initial offerings, the context and language of Section 12(2), the fiduciary relationship Section 12(2) creates, and sound public policy.

ARGUMENT

A. The 1933 Act Regulates Initial Offerings and its Civil Remedies are Limited to that Context

"The 1933 Act regulates initial distributions of securities and the 1934 Act for the most part regulates post-distribution trading." *Central Bank of Denver v. First Interstate Bank of Denver*, 114 S. Ct. 1439, 1445 (1994). The drafters of the 1933 Act articulated its limited scope, stating "[t]he bill affects only new offerings of securities. . . . It does not affect the ordinary redistribution of securities". H. Rep. No. 85, 73rd Cong., 1st Sess. 5 (1933) (the "House Report").

> The exemption sections, 3 and 4, exempt, among other transactions in securities, transactions by individuals; the execution by brokers of customer's orders in open market; transactions by a dealer in securities not connected by time or circumstance with distribution of a new offering; * * * * In view of these exemptions *and the restriction of the bill's application to new offerings*, the bill does not affect transactions beyond the need of public protection in order to prevent recurrences of demonstrated abuses.

Id. at 6-7 (emphasis supplied).

As to the offerings it does regulate, the Act requires full disclosure of information by means of its registration requirements and adequate dissemination of such information by means of its prospectus delivery requirements. The civil remedies of the Act, consistent with this regulatory structure, apply only to misstatements "in the registration statement and the prospectus – the basic information by which the public is solicited." *Id.* at 9. They impose a duty which "varies in its demands upon participants in security distribution with the importance of their place in the scheme of distribution and with the degree of protection that the public has a right to expect." *Id.* at 9. The constitutionality of the liability provisions was derived from the fact that, "[e]ven though the activities of particular persons concerned may be actually intrastate in character, they are, nevertheless, an integral part of a process calling for the interstate distribution of securities." *Id.* at 10. All these statements are patently inaccurate if Section 12(2) extends beyond initial distributions.

The Act's fiduciary based standards of disclosure and civil liability flow from the element of "trusteeship" applicable in the context of initial offerings. The President's letter recommending the legislation stated that those "handling or using other people's money are trustees acting for others." *Id.* at 2. The Act's civil liability provisions are a demand that persons "who sponsor the investment of other people's money should be held up to the high standards of trusteeship." *Id.* at 3. He should suffer the loss "who occupies a position of trust

in the issuing corporation toward the stockholders." S. Rep. No. 47, 73rd Cong., 1st Sess. 5 (1933).

Unique civil remedies applicable to initial offerings were necessary because the common law was not "consciously and especially molded for the flotation of securities." H. Shulman, *Civil Liability and the Securities Act*, 43 Yale L.J. 227 (1933) ("Shulman"). Only in the context of initial offerings are the provisions of Section 12 of the Act appropriate:

– Section 12(2) only provides remedies to buyers which makes sense in the context of regulating initial offerings but not in secondary transactions where misrepresentations can also be made by a buyer;

– A negligence standard of fault is reasonable only as to those seeking to become "trustees" of "other people's money";[1]

– The lack of any reliance requirement is reasonable only in the context of initial distributions where misstatements "because of their wide dissemination, determine the market price of the security". House Report at 10;

– Sellers in initial distributions should be liable because they are the investors' primary source of information about the security unlike many secondary transactions where other information regarding the value of the stock exists;

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[1] The drafters explained that "[t]he committee is fortified in these [liability] sections by similar safeguards in the English Companies Act of 1929." House Report at 9. If Section 12(2) applied to secondary transactions as well as initial offerings, this statement was inaccurate because The British Companies Act imposed prospectus liability only in the context of solicitation of the public, defining prospectus as "any prospectus, notice, circular, advertisement, or other invitation, offering to the public for subscription or purchase any shares or debentures of a company." 19 and 20 Geo. 5, ch. 23 § 37, § 308(1) (1929). That a similar meaning of prospectus was intended for purposes of imposition of Section 12(2) liability is the only reasonable inference from the characterization of the liability provisions in the Act as "similar".

– Allowing rescissionary damages as an alternative to rescission is reasonable in public offering contexts because a market exists for the security;[2] and

– If Section 12(2) were to apply to secondary market trading, its lack of scienter and reliance requirements would effectively eliminate the use of Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act") by securities purchasers.

As to the "exact scope" the drafters wanted the Securities Act to cover, " 'Public offerings' as distinguished from 'private offerings' proved to be the answer." J. Landis, *The Legislative History of the 1933 Securities Act*, 28 Geo. Wash. L. Rev. 29, 37 (1959) ("Landis").

The language and context of Section 12(2) comport totally with the conclusion that it does not apply to secondary transactions. Referring to the *combined* import of the prospectus required by Section 10 and the definition of prospectus in Section 2, the House Report stated that "The full revelations required in the filed 'registration statement' should not be lost in the actual selling process." House Report at 10. It is for this reason that liability attaches under Section 12(2) only when securities are sold by means of a misleading prospectus, then defined as "a document . . . inviting the public to subscribe to the issue." Black, *A Law Dictionary*, 959 (2d Ed. 1910); *accord, Black's Law Dictionary* 1451 (3d Ed. 1933); Higgs, *Palgrave's Dictionary of Political Economy*, 233 (1924) ("the name for a notice calling the attention of the

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[2] This expansion from the common law was justified because "All shares of an issue are alike. They are readily obtainable in the market. The price at any specific time is reasonably fixed." Shulman at 245. Thus, it makes little difference to a seller found liable under Section 12(2) whether the buyer returns the security or obtains recissionary damages because the seller could replace the security he sold. *Id.* at 245-246. This justification does not apply, as in this case, where restoration of the status quo ante cannot be accomplished.

public to the issue of any stock").[3] This commonly understood meaning is even more clearly applicable in light of Section 12(2)'s proximity to Sections 11 and 12(1) in the Act, which apply only in the context of the public distributions regulated by the Act.

It would be totally inconsistent with the foregoing to apply Section 12(2) broadly to embrace a negotiated private resale transaction or an ordinary trading transaction on an exchange. As observed by Prentice:

> Given that the entire thrust of the '33 Act was to reform the distribution process, not secondary trading, congressional silence on the matter must be read as indicating that Section 12 should be construed consistently with that purpose. Section 11 is almost always limited to distributions, as is section 12(1). If Section 12(2) were intended to break out of this mold, one would expect some sort of express statement by Congress.

Prentice at 123.

Respondents erroneously contend that the combination of Sections 2(10) and 12(2) creates an all-encompassing remedy extending well beyond the otherwise limited focus of the Act, applying to *every* transaction, whether or not otherwise exempt from the Act, which involves *any* security. If they are correct, Congress should instead have written Section 12(2) to state "by means of any communication." That Congress knew how to create broader coverage is shown by the language it used in Section 17(a) of the Act which does apply to secondary transactions. *United States v. Naftalin*, 441 U.S. 768

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[3] This was also made clear by the statement that actions could not be brought under Sections 11 or 12 more than ten years "after the security was offered to the public." House Report at 24. This meaning is also compelled as to the definition of "prospectus" at Section 2(10) of the Act under the maxim *noscitur a sociis* since the words used there to define "prospectus" refer to the types of communications which commonly occurred in connection with public offerings, not private transactions or ordinary aftermarket trading. In any event, Section 2's introductory admonishment that its definitions apply "unless the context otherwise requires" obviously permits the more reasonable interpretation of the meaning of Section 12(2) urged by Petitioners.

(1979). That it did not use such broad language in Section 12(2) shows its intent to limit the transactions as to which that Section imposed liability. To conclude otherwise would improperly render the words used mere surplusage in violation of a cardinal rule of statutory construction. *Ballay*, 925 F.2d at 688-89.

Moreover, Section 2(1) of the Act defines "security" extremely broadly, including any note, evidence of indebtedness, investment contract, etc. Imposition of fiduciary based liability in the many contexts which may be embraced if the exemptions from the Act are superseded and the underlying primary purpose of the Act is ignored must require a compelling showing that such liability was intended, a showing which has not been, and cannot be, made by Respondents.

B. Section 12(2) Does Not Apply to Negotiated Private Secondary Transactions or Ordinary Aftermarket Trading

As discussed above, the Act's coverage was limited to public offerings. The clearest type of secondary transaction to which Section 12(2) does not apply is that involved here, the resale of long outstanding stock in a negotiated transaction to a sophisticated venture capital investor fully able to fend for itself.[4] "The sale of an issue of securities to insurance companies or to a limited group of experienced investors, was certainly not a matter of concern to the federal government." Landis at 37. *See SEC v. Ralston Purina Co.*, 346 U.S. 119, 124-25 (1953). Similarly not covered would be a private sale of 100 shares of stock and the many sales of small businesses such as restaurants, gas stations, barber shops, medical practices or whatever which occur daily. Unlike initial offerings

[4] As some courts have recognized, there may be some secondary distributions which take on the characteristics of an initial public offering. *Ballay*, 925 F.2d at 690. Space does not permit full discussion of application of Section 12(2) to those transactions. However, there is no dispute that the transaction involved in this case does *not* have the characteristics of an initial public offering. *See* J. Williams opinion in this case at p. 12. Joint Appendix at 21.

and comparable transactions, these transactions are not regulated by the Act.[5]

The most ordinary type of secondary transaction occurs millions of times weekly, namely, ordinary aftermarket trading on exchanges. Such trading is exempt by Section 4 from registration under the Act (except when related to securities involved in offerings), *see generally United States v. Wolfson*, 405 F.2d 779 (CA2), *cert. denied*, 394 U.S. 946 (1969), but regulated extensively by the 1934 Act. To impose a fiduciary duty on one merely selling for customers for modest compensation is unreasonable. Furthermore, outside the offering context (in which the offeror is obligated to prepare a registration statement and deliver a prospectus upon which brokers or dealers may reasonably rely), brokers or dealers selling stock simply do not have access to the information necessary to satisfy the requirements of Section 12(2).[6]

As described fully in the Securities Industry Association's brief at 19-24, brokerage firms frequently distribute research applicable to various companies, the securities of which such firms may sell. Such research represents the best analysis possible given time constraints and without full information and serves a valuable role with regard to the efficient operation of capital markets. With the

[5] Private transactions are exempted from the registration and prospectus delivery requirements of the Act whether they involve initial offerings or resales. As to issuers making *private* offerings the transaction is exempt by Section 4(2); *private* resales by non-controlling shareholders are exempted by Section 4(1); *private* resales by sellers who control the issuer are exempt under the "Section 4 1/2 exemption" which reflects the statutory relationship between Section 4(1) and 4(2) in light of the definition of underwriter in Section 2(11). *See, Ackerberg v. Johnson*, 892 F.2d 1328, 1335, n. 6 (CA8 1989); ABA Report, *The Section "4 (1 1/2)" Phenomenon: Private Resales of "Restricted" Securities*, 34 Bus. Law 1961 (1979); C. Schneider, *Section 4 (1 1/2) – Private Resales of Restricted or Control Securities*, 49 Ohio St. L. J. 501 (1988).

[6] The Act applies to "registrations of offerings of securities under circumstances when the public interest might deem it wise to institute a system of controls – controls that have to be molded to the ability of the various types of sellers of securities to comply with their requirements. Issuers of securities, for example, can meet certain conditions that non-controlling holders who desire to market their holdings obviously cannot meet. This distinction, so important to any understanding of the scope of the Securities Act of 1933, had never therefore [sic] been recognized by the state blue sky laws." Landis at 32.

benefit of hindsight, after a security performs poorly, almost any report can be read as misstating or omitting a material fact. It would be totally unfair to impose a fiduciary duty on firms doing no more than selling shares and attempting to distribute useful research. More unreasonable would be such liability when the broker is deemed a seller when executing orders to sell pursuant to customer requests, receiving only a commission. *See, Pinter v. Dahl*, 486 U.S. 622 (1988).

That the 1933 Act did not regulate secondary transactions was confirmed by the criticisms of legislators who felt such regulation should have been included, the lack of any response that coverage was afforded by Section 12(2), the promise that regulation would be forthcoming in additional legislation, and the portions of the 1934 Act which in fact provided such regulation a year later. "[I]t took no powers of prognostication for Congress to conclude that the '33 Act should be limited to reforming distribution transactions. Formal introduction of bills to address [problems in the secondary market] was inevitable." Prentice at 118.[7] The 1933 and 1934 Acts should be considered, as they were to a significant extent adopted, in harmony. "The negligence standard of sections 11 and 12 has proved the primary remedy in distributions, and the scienter standard of section 10(b) has provided the primary remedy for misconduct in the secondary market." *Id.* at 139; *see also, Ballay*, 925 F.2d at 692.

C. Public Policy Precludes Application of Section 12(2) to Secondary Transactions

The impact of making one side a fiduciary of the other in negotiated transactions would be "so bizarre" that even if Congress

[7] The types of manipulative and deceptive transactions in "old stock" such as wash sales, pegging transactions, pooling arrangements, insider trading and the like which are explicitly proscribed by Sections 9 and 10 of the 1934 Act were, under the view of Section 12(2) presented by Respondents, already amply regulated by Section 12(2). A pooling group could not possibly induce purchases of stock if they disclosed the fact of pooling in advance. Similarly, one could not successfully engage in wash sales or pegging transactions if the material facts relating to such transactions were disclosed in advance. If Congress intended that Section 12(2) was to apply to all of these types of secondary transactions, then the specific prohibitions of the 1934 Act would be in large part redundant.

has used words appearing on their face to intend such a result, the Court would be warranted in concluding no such application was intended. *Demarest v. Manspeaker*, 498 U.S. 184, 191 (1991). Such bizarre results are shown here where, in the context of months of negotiation, extensive due diligence and a written agreement that included an express agreement that all prior oral representations were superseded, Buyers nonetheless attempt to isolate alleged oral representations as a basis for Section 12(2) liability. In any such transaction a buyer can nearly always – but perhaps solely for negotiating leverage – isolate a statement or omission upon which a claim of liability could be stated under the extraordinarily lenient standard of proof of Section 12(2). Indeed, it might be argued that such a private seller is not even permitted to bargain. If, in fact, a seller asks $125,000 for a business really believed to be worth $100,000, failure to disclose that fact arguably would constitute a material omission.

Nor is a fiduciary duty appropriate in ordinary aftermarket trading transactions on exchanges. As in *Ballay*, analysis by an employee and oral statements over a "squawk box" resulted at the trial level in liability exceeding $1,000,000 to 41 plaintiffs suing a firm which received nothing more than commissions. Such liability is proper and permitted when the scienter required by the 1934 Act is involved, but is inappropriate under the simple negligence standard of Section 12.

As this Court explained in *Central Bank of Denver*, 114 S. Ct. at 1454, a broad and ambiguous standard of liability "exacts costs that may disserve the goals of fair dealing and efficiency in the securities markets" and is not a satisfactory rule as to the conduct of business transactions because of the significant potential for strike suits. These concerns are even more compelling with respect to Section 12(2) which requires no more fault than simple negligence, requires no reliance or causation and allows damages significantly greater than the measure ordinarily applied to deceptive statements. *See, Ross v. Bank South, N.A.*, 885 F.2d 723, 743 (CA11 1989).

CONCLUSION

Section 12(2) does not apply to secondary market transactions, including the privately negotiated contractual resale which occurred in this case.

Respondents and the SEC ask the Court to apply Section 12(2) far beyond the primary scope of the Act by incorporating a definition developed for purposes of the Act's registration requirements into Section 12(2) and ignoring the context and purpose of the Section. This Court in *United States v. Naftalin*, 441 U.S. 768 (1979), determined that a departure from the primary purpose of the Act requires an exceptional showing. There is no such showing that Section 12(2) was meant to depart broadly from the general scope of the Act.

Section 12(2) does not apply to privately negotiated secondary transactions or ordinary aftermarket transactions. This is connoted by Congress' use of the phrase "by means of a prospectus or oral communication" in Section 12(2) rather than the obvious and broader phrase "by means of any communication." Congress did not use such broader language because, consistent with the primary scope of the Act, Section 12(2) applies to sellers choosing to make initial offerings to the public. That is the commonly understood context in which a "prospectus" is prepared and distributed and the only context in which Section 12(2)'s fiduciary based remedy is fair and reasonable.

Respectfully submitted,

DONALD W. JENKINS*
THOMAS P. DESMOND
JENNIFER R. EVANS

VEDDER, PRICE, KAUFMAN & KAMMHOLZ
222 North LaSalle Street
Chicago, IL 60601
(312) 609-7500

Counsel for Petitioner Arthur L. Gustafson

*Counsel of Record

HAROLD C. WHEELER*
PETER C. WOODFORD
DEBRA A. WINIARSKI

SEYFARTH, SHAW, FAIRWEATHER & GERALDSON
55 East Monroe Street
Chicago, IL 60603
(312) 346-8000

Counsel for Petitioners Daniel R. McLean and Francis I. Butler

*Counsel of Record

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No. 93-404

In the Supreme Court of the United States

OCTOBER TERM, 1993

ARTHUR L. GUSTAFSON, ET AL., PETITIONERS

v.

ALLOYD CO., INC., ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE SUPPORTING RESPONDENTS

DREW S. DAYS, III
Solicitor General
EDWIN S. KNEEDLER
Deputy Solicitor General
MICHAEL R. DREEBEN
Assistant to the Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 514-2217

SIMON M. LORNE
General Counsel
PAUL GONSON
Solicitor
JACOB H. STILLMAN
Associate General Counsel
BRIAN D. BELLARDO
Assistant General Counsel
MARK PENNINGTON
Special Counsel
Securities and Exchange Commission
Washington, D.C. 20549

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QUESTION PRESENTED

Whether Section 12(2) of the Securities Act of 1933 is applicable to a privately negotiated resale of all the stock of a corporation.

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No. 93-404

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BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE SUPPORTING RESPONDENTS

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission (SEC or Commission) is responsible for the administration and enforcement of the federal securities laws. This case involves the scope of Section 12(2) of the Securities Act of 1933, 15 U.S.C. 77*l*(2), the express private right of action for the sale of securities by means of materially false or misleading representations. Private actions under the securities laws serve as a necessary supplement to Commission enforcement actions and provide compensation to injured investors. The Commission therefore has an interest in this case.

STATEMENT

1. In 1989, petitioners, the shareholders of Alloyd Co. (Old Alloyd), a manufacturer of clear plastic blister packaging and heat seal packaging equipment, decided to sell the company. Petitioners retained KPMG Peat Marwick to solicit potential purchasers. In response to the solicitation, respondent Wind Point Partners II (Wind Point) expressed interest in acquiring Old Alloyd. Following negotiations, Wind Point formed a corporation called Alloyd Holdings, Inc., as a vehicle for acquiring the stock of Old Alloyd. J.A. 10-11. Alloyd Holdings, Inc., and petitioners then entered into a stock purchase agreement. J.A. 87-161. On December 20, 1989, the transaction closed, and the name of the new company was changed to respondent Alloyd Co., Inc. J.A. 12.

By February 1990, respondents learned that Old Alloyd's 1989 earnings and year-end book value were significantly less than the estimates used to calculate an adjustment payment at closing. J.A. 12. That discrepancy led to the instant litigation.

2. On February 11, 1991, respondents commenced an action against petitioners alleging a claim under Section 12(2) of the Securities Act of 1933 (Securities Act or Act), 15 U.S.C. 77*l*(2), and a breach of contract claim. J.A. 12, 23-36, 81. The complaint alleged that petitioners materially overstated Old Alloyd's 1989 earnings, both orally and in the stock purchase agreement. As relief, respondents sought to rescind the sale of Old Alloyd's stock. J.A. 32-33.

The district court granted summary judgment in favor of petitioners and dismissed the complaint. J.A. 10-22. Relying on *Ballay* v. *Legg Mason Wood Walker, Inc.*, 925 F.2d 682 (3d Cir.), cert. denied, 112 S. Ct. 79 (1991), the court held that Section 12(2) applies only to initial public distributions of stock, not to aftermarket trading. J.A. 20. The court also concluded that the transaction was not comparable to an initial offering, because the transaction had occurred about 30 years after Old Alloyd had originally issued its stock, and that, "unlike purchasers in most initial offerings, the purchasers in this case had direct access to financial and other company documents, and had the opportunity to inspect the seller's property."[1] J.A. 21.

3. While respondents' appeal was pending, the court of appeals issued its decision in *Pacific Dunlop Holdings, Inc.* v. *Allen & Co.*, 993 F.2d 578 (7th Cir. 1993), cert. granted, 114 S. Ct. 907, cert. dismissed, 114 S. Ct. 1146 (1994). In that case, the court of appeals rejected the reasoning of *Ballay* and held, based on the language, structure, and legislative history of the Securities Act, that Section 12(2) applies not only to initial public distributions of securities, but also to secondary transactions, including a privately negotiated stock purchase agreement. 993 F.2d at 595. Based on its holding in *Pacific Dunlop*, the court of appeals granted respondents' motion to vacate the district court judgment and to remand the case for further proceedings. J.A. 8-9.[2]

SUMMARY OF ARGUMENT

Section 12(2) of the Securities Act of 1933 provides a private remedy for false or misleading statements used by any person who offers or sells a security "by means of a prospectus or oral communication." The Act specifically defines "prospectus" to include "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale." In light of the definition of "prospectus," Section 12(2) covers all communications in securities sales, whether public or private, initial or secondary. Nothing in the text of the Act limits Section 12(2) to initial public distributions or exempts private or secondary market sales from that express remedy. Nor does the context of the Act support a departure from the defined term "prospectus" as used in Section 12(2).

The statutory structure strongly reinforces the conclusion that Section 12(2) is applicable to misrepresentations and mis-

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[1] Having dismissed the Section 12(2) claim, the court held that it lacked jurisdiction over the breach of contract claim. J.A. 21-22.

[2] On remand, a magistrate recommended, in light of *Pacific Dunlop*, that petitioners' motion for summary judgment on the Section 12(2) claim be denied. J.A. 81-86.

leading statements in all types of securities sales. Congress carved out exemptions for private sales and for ordinary aftermarket trading from the registration requirements of the Act. No similar exemption, however, was applied to Section 12(2). That provision, like the antifraud provision enforced by the government, was made applicable to all types of securities transactions.

Contrary to petitioners' contention, the legislative history affords no basis for restricting Section 12(2) to initial public distributions. The drafting history of the Securities Act indicates, in fact, that Section 12(2) was deliberately freed from exemptions for private and aftermarket transactions that apply elsewhere in the Act. While the committee reports make clear that the principal focus of the Securities Act was on regulation of initial public distributions, that was by no means the only focus of the Act. The reports thus provide no basis for overriding the scope of Section 12(2) suggested by its language and the Act's structure. And Section 12(2)'s application beyond initial public distributions is confirmed by contemporaneous commentators and the consistent view of administrators of the Act.

Finally, policy concerns do not justify limiting Section 12(2) to initial or public transactions. This Court has declined to consult the general purposes of the Act when the meaning of specific provisions can be determined from text, structure, and history. In any event, the claim that Section 12(2) is unnecessary in private transactions is unfounded; to the extent that Congress believed that a relaxed form of regulation of private transactions is appropriate, it provided that relief by exempting private transactions from registration. And, to the extent that policy concerns are raised by applying Section 12(2) to sales in the public securities markets, the remedy for those concerns is legislative or administrative action; the courts cannot fashion exceptions to statutory provisions solely to accommodate perceived policy considerations.

ARGUMENT

SECTION 12(2) OF THE SECURITIES ACT OF 1933 IS APPLICABLE TO THE STOCK PURCHASE AGREEMENT IN THIS CASE

From the enactment of the Securities Act of 1933 until the 1980s, it was well accepted that Section 12(2) applies not only to initial public distributions, but also to aftermarket sales and privately negotiated transactions. That view has long been held by the Commission; it is based in the language of Section 12(2), which covers all types of securities sales made by means of false or misleading written or oral communications; and it accords with the statute's structure and background. In the courts below, petitioners' main contention was that Section 12(2) is limited to initial distributions and does not cover resale transactions.[3] In this Court, petitioners have shifted ground somewhat and now argue that Section 12(2) does not apply to privately negotiated transactions, such as the transaction in this case.[4] In our view, both of those interrelated contentions are incorrect: Section 12(2)'s remedy applies to false or misleading statements in the sale of securities, whether the sale involves an initial distribution to the public, a secondary transaction in the aftermarket, or a privately negotiated sale.[5]

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[3] See Defendants' Memo. In Support Of Mot. For Summary Judgment (filed Oct. 31, 1991, see J.A. 1), at 11-12 ("[T]he sale of Alloyd shares to Holdings was a negotiated resale—a secondary market transaction—not a primary or initial offering of securities. Section 12(2) applies only to material misrepresentations or omissions in the course of a primary or initial offering of securities to the public. *Ballay v. Legg Mason Wood Walker, Inc.* * * *.").

[4] We note that the question presented by the petition encompasses not only the issue of whether Section 12(2) applies to a "privately negotiated" sale of all of a company's stock, but also whether it applies to "resale" transactions. Pet. i. In their merits brief, petitioners have narrowed the question presented to focus on whether Section 12(2) applies to private negotiated transactions. Pet. Br. i. While the courts of appeals have divided on whether Section 12(2) applies to secondary trading in the aftermarket, there is no circuit split on whether Section 12(2) applies to private transactions; the courts have uniformly held that Section 12(2) *does* apply to private transactions. See note 29, *infra*.

[5] The Act does not contain definitions that explicitly distinguish among various types of securities transactions that Section 12(2) covers. It is generally

A. The Language Of Section 12(2) Covers Private Sales And Resale Transactions As Well As Initial Public Distributions

1. Section 12(2) of the Securities Act states that "[a]ny person who * * * offers or sells a security * * * by means of a prospectus or oral communication" containing a material misrepresentation or omission is liable to the purchaser for rescission of the transaction or for damages. 15 U.S.C. 77*l*(2). Section 2(10) of the Act defines "prospectus" to mean "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale." 15 U.S.C. 77b(10). The text of those provisions establishes a private remedy for misrepresentation that comprehensively covers securities sales.[6]

Nothing in Section 12(2)'s language restricts the provision's application to securities sales in initial or public transactions. The provision applies to all written or oral communications used in offers or sales of securities—with a single express exception. The Act provides that Section 12(2) does not apply to securities that are exempted from the Act by Section 3(a)(2), 15 U.S.C. 77c(a)(2), which, generally speaking, are securities issued or guaranteed by the United States, a State, a municipality, or government instrumentality, and securities issued by national or state banks. Apart from sales involving those exempt securities, Congress did not restrict the remedy provided in Section 12(2) to particular types of securities sales or transactions.

Petitioners seek to limit Section 12(2)'s broad coverage by relying on the term "prospectus," which, in their view, refers only to a document used by an issuer to "solicit investments

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understood, however, that an "initial offering" of securities is a sale of securities by the issuer and a "secondary" sale is a subsequent transaction. Initial offerings are, generally speaking, of two types—public and private. An "initial distribution" is understood to be a public offering of securities by the issuer; a "private placement" is an issuer's sale of its securities not involving a public offering. Secondary sales are generally either public resales of stock on organized securities markets or private resales.

[6] The texts of Sections 2(10) and 12(2) of the Securities Act are set out in the appendix to this brief.

from public investors," and which therefore has the effect of limiting Section 12(2) to initial public offerings. Pet. Br. 17; see Securities Industry Association, Inc. (SIA) Amicus Br. 4-9. As defined in the Act, however, the word "prospectus" has a wider significance. Section 2(10) does define the term "prospectus" to include "any prospectus"—and thus to include a document prepared by or on behalf of an issuer to solicit the public to purchase securities. See, *e.g.*, *Black's Law Dictionary* 1451 (3d ed. 1933). Section 2(10), however, also defines a prospectus to include "any * * * notice, circular, advertisement, letter, or communication * * * which offers any security for sale." While one of the functions of that list is to prevent issuers from circumventing the Act by calling a "prospectus" by another name, see SIA Amicus Br. 7, the origins of Section 2(10) indicate that Congress intended the defined term "prospectus" to go beyond documents used in public distributions.[7]

The point of departure for the drafters of the Securities Act was the British Companies Act, 19 & 20 Geo. 5, ch. 23 (1929). See James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29, 34 (1959) (the drafters of the Act "determined to take as the base of our work the English Companies Act");[8] see also *SEC* v. *Ralston Purina Co.*, 346 U.S. 119, 123 (1953) (characterizing the Companies Act as

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[7] Under the regulatory scheme of the Act, a public offering of securities by an affiliate of the issuer through an underwriter is required to be registered under Section 5 of the Act, and the Act requires the use of a formal prospectus, described in Section 10 of the Act, in the offer or sale of those securities. 15 U.S.C. 77e, 77j. Thus, even in its narrowest usage, a formal prospectus is not limited to a document used in offers or sales by the *issuer*, but also includes public sales by affiliates as well.

[8] Shortly after President Roosevelt sent a message to Congress urging the adoption of securities legislation, Representative Sam Rayburn, through the White House, requested assistance in drafting a bill. Landis, who was in 1933 a professor at Harvard Law School and who was later to become Chairman of the Securities and Exchange Commission, was requested by then-professor Felix Frankfurter to prepare a draft bill. Landis, along with Benjamin V. Cohen and Thomas G. Corcoran, took principal responsibility for preparing the initial draft of the House bill; that bill formed "[t]he core of the Securities Act of 1933." James M. Landis, *supra*, 28 Geo. Wash. L. Rev. at 33-34.

a "statutory antecedent[ ]" of federal securities laws); 78 Cong. Rec. 8675-8695 (1934) (reprinting in parallel columns the comparable provisions of the Securities Act and Companies Act). The Companies Act defined "Prospectus" to mean "any prospectus, notice, circular, advertisement, or other invitation, offering to the public for subscription or purchase any shares or debentures of a company." 19 & 20 Geo. 5, ch. 23, § 380(1) (1929). The drafters of the Securities Act borrowed the first four terms in the definition of "prospectus" from the Companies Act, but then departed from it significantly. Rather than limiting the term "prospectus" to an "offering to the public," as did the Companies Act, the Securities Act drafters omitted that language and instead added the expansive phrase "any * * * letter, or communication * * * which offers any security for sale." The new formulation suggests that, in deliberate contrast to the Companies Act, the drafters of the Securities Act wanted the term "prospectus" to include more than documents used in public offerings.[9]

In an effort to confine Section 2(10) to documents soliciting the public in an initial offering, petitioners invoke the canon *noscitur a sociis*, "a word is known by the company it keeps." *Jarecki* v. *G.D. Searle & Co.*, 367 U.S. 303, 307 (1961). According to petitioners, all of the words in Section 2(10) should be read as applying only to initial public distributions because one of them (*i.e.*, "prospectus") is so limited. Pet. Br. 19-21; see SIA Amicus Br. 7-8. The canon on which petitioners rely is inapplicable here. The listed terms in Section 2(10) include such diverse forms of offering a security for sale as notices, circulars, advertisements, letters, written communications, and radio communications. To give all of those terms the narrow connotation associated with the word "prospectus" stands *noscitur a sociis* on its head: it is to construe every word in a list narrowly because of

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[9] In 1954, Congress added two additional terms to the definition of "prospectus": "television" communications and communications that "confirm[ ] the sale of any security." Act of Aug. 10, 1954, ch. 667, § 3, 68 Stat. 683. Those additions confirm Congress's intention to embrace all forms of communication that occur in securities sales.

the meaning of just one of its words. This Court has declined to make such use of the canon of *noscitur a sociis*. See *Russell Motor Car Co.* v. *United States*, 261 U.S. 514, 519 (1923) (rejecting argument that "inasmuch as the application of [one word in a statutory list] must be confined to private contracts, the other words associated with it must be likewise restricted").[10]

While Congress could have used other phrases in Section 12(2) to express an intention to cover all communications that offer a security for sale, see Pet. Br. 21; SIA Amicus Br. 9, the phrase "prospectus or oral communication" was a useful way to underscore that Congress intended to cover not just written communications, but also broadcasts and oral statements. Nor should the phrase "prospectus or oral communication" in Section 12(2) be limited to initial or public transactions on the theory that the phrase would otherwise be superfluous.[11] Pet. Br. 22. The Securities Act is characterized by the use of phrases

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[10] *Noscitur a sociis* has its greatest claim to application in response to a party's assertion that one word in a list should be given a meaning that is unrelated to the connotations shared by all of the words on the list. For example, in *Jarecki* the Court considered a statute that gave special tax treatment to any income resulting from "exploration, discovery, or prospecting"; the taxpayer asserted that a new drug constituted a "discovery." 367 U.S. at 307. The Court rejected that reading of "discovery," observing that the words "in conjunction * * * all describe income-producing activity in the oil and gas and mining industries, but it is difficult to conceive of any other industry to which they all apply." *Ibid.* Similarly, in *Securities Industry Association* v. *Board of Governors of the Federal Reserve System*, 468 U.S. 207, 218 (1984), the Court construed the phrase "public sale" in light of the accompanying words "issue, flotation, underwriting * * * or distribution," which all have the common feature of relating to underwriting activity. See also *Beecham* v. *United States*, 114 S. Ct. 1669, 1671 (1994). Here, the words in the list – prospectus, notice, circular, advertisement, letter, written communication, and radio communication – do not all share the characteristic of being restricted to initial or public transactions.

[11] Petitioners refer to Section 410(a)(2) of the Uniform Securities Act, 7B U.L.A. 643 (1985), which omits the phrase "by means of a prospectus or oral communication," as an example of how Congress might have drafted Section 12(2) more efficiently if it had desired the Section to reach beyond initial public offerings. Pet. Br. 21. But the principal drafter of the Uniform Act has

intended to denote breadth and emphasis, even if a briefer formulation might have been available. See, *e.g.*, Section 5(a)(1) of the Act, 17 U.S.C. 77e(a)(1) (prohibiting the selling of unregistered securities "through the use or medium of any prospectus or otherwise"). The argument that the statute could have been drafted more concisely does not justify overriding Congress's use of expansive terms; it would be paradoxical to view Section 12(2) as covering only a narrow range of transactions, when Congress used a group of words with a range of meanings in Section 2(10) to define the term "prospectus" inclusively.

2. Section 2 of the Act states that its definitions are applicable "unless the context otherwise requires." 15 U.S.C. 77b. Nothing in the context of Section 12(2) or the balance of the Act requires a departure from the definition of "prospectus" for purposes of Section 12(2). Some sections of the Act do use the word "prospectus" to refer, in context, to the formal selling documents associated with registered offerings of securities. For example, Section 10(a), 15 U.S.C. 77j(a), refers to "a prospectus [that] * * * shall contain the information contained in the registration statement"; Section 10(b), 15 U.S.C. 77j(b), refers to "[a] prospectus * * * filed as part of the registration statement"; and Section 5(b)(1), 15 U.S.C. 77e(b)(1), refers to "any prospectus relating to any security with respect to which a registration statement has been filed under this title, unless such prospectus meets the requirements of Section 10."

The distinction between "prospectus" as broadly defined in the Act to mean every kind of written communication that offers a security for sale, on the one hand, and a formal prospectus meeting the requirements of Section 10, filed by the issuer with its registration statement, on the other, has long been recognized. See, *e.g.*, *Opinion of General Counsel Concerning the Application of the Third Clause of Section 4(1) in Various Situations*, Securities Act of 1933, Rel. No. 2623, 1941 SEC LEXIS 346, at *4-*6 (July 25, 1941), *reprinted at* 11 Fed. Reg.

explained that Section 410(a)(2) has the same meaning as Section 12(2), and that Section 12(2) applies to all types of securities sales. Louis Loss, *Securities Act Section 12(2): A Rebuttal*, 48 Bus. Law. 47, 51-52 (1992).

10,964 (1941) ("[T]he term 'prospectus' as used in the Securities Act covers more than the kind of formal document which the layman ordinarily has in mind when he uses the term."). Congress explicitly recognized that distinction in the definition of "prospectus" in Section 2(31) of the Investment Company Act of 1940, 15 U.S.C. 80a-2(31):

> "Prospectus," as used in [section 22 of the Investment Company Act], means a written prospectus intended to meet the requirements of section 10(a) of the Securities Act of 1933 * * * and currently in use. As used elsewhere, "prospectus" means a prospectus as defined in the Securities Act of 1933.

In contrast to other sections of the Act, Section 12(2) does not contain language restricting "prospectus" to documents filed in connection with registered offerings. In fact, Section 12(2) explicitly covers securities and transactions that are exempt from registration.[12] As to those exempt securities and transactions, "prospectus" in Section 12(2) necessarily includes communications other than those used in initial public offerings registered under the Act, because registration and the use of a formal prospectus are not required for those securities and transactions.

The context of the Act as a whole provides no greater justification for a limitation of Section 12(2) to public or initial sales. While a principal purpose of the Act is to regulate initial public offerings, see Pet. Br. 32-36, this Court recognized in *United States* v. *Naftalin*, 441 U.S. 768, 777-778 (1979), that the Act has other significant purposes as well. In *Naftalin*, the Court rejected the argument that Section 17(a) of the Act, 15 U.S.C.

[12] Section 12(2) applies to "a security (whether or not exempted by the provisions of [Section 3], other than [Section 3(a)(2)])." Section 12(2) thus explicitly applies to all but one of the categories of exempt securities in Section 3, 15 U.S.C. 77(c), including, *inter alia*, short term commercial paper, securities issued by charitable or non-profit enterprises, securities of certain savings and loan associations, securities subject to regulation by the Interstate Commerce Commission, and securities issued by a bankruptcy trustee, as well as to transactions exempted by Section 4. Section 12(2) is inapplicable only to government and bank securities and other securities specifically enumerated in Section 3(a)(2).

77q(a), the antifraud provision enforced by the government, does not apply to aftermarket trades because the Act was " 'preoccupied with' the regulation of initial public offerings of securities, and * * * Congress waited until the Securities Exchange Act of 1934 to regulate abuses in the trading of securities in the 'aftermarket.' " 441 U.S. at 777. While recognizing that the Act is "primarily concerned" with new offerings, *id.* at 777-778, the Court noted that the Act is not limited to that purpose, and that Section 17(a) "was intended to cover any fraudulent scheme in an offer or sale of securities, whether in the course of an initial distribution or in the course of ordinary market trading." *Id.* at 778. Section 12(2), like Section 17(a), addresses misstatements in connection with the sale of securities, and *Naftalin*'s observation about Section 17(a) is equally applicable here: the provision "makes no distinction between" initial public distributions and secondary market sales. 441 U.S. at 778.

B. The Structure Of The Securities Act Confirms The Scope Of Section 12(2)'s Coverage

The application of Section 12(2) to private transactions and market trading, as well as to initial public distributions, draws significant support from the structure of the Securities Act. That structure indicates that, when Congress wished to restrict the Act's requirements to initial distributions, it did so through specific exemptions. No such exemptions are applicable to Section 12(2).

1. The heart of the Securities Act is the registration requirement. *Pinter* v. *Dahl,* 486 U.S. 622, 638 (1988). Section 5(a) of the Act prohibits the sale of any security "[u]nless a registration statement is in effect as to [that] security." 15 U.S.C. 77e(a). Section 4, however, expressly exempts from the requirements of Section 5 both "transactions by an issuer not involving any public offering," Section 4(2), 15 U.S.C. 77d(2), and most secondary sales after an initial public offering, Sections 4(1), 4(3), and 4(4), 15 U.S.C. 77d(1), (3), and (4).[13] If Congress had intended to exclude private or secondary market sales from the reach of Section 12(2), it would have made the Section 4 exemptions applicable, not only to the registration requirement of Section 5, but also to the private cause of action under Section 12(2). As this Court reasoned in *Landreth Timber Co.* v. *Landreth,* 471 U.S. 681, 692 (1985), in rejecting the argument that a private sale of all of a company's stock was not a transaction in securities, "although § 4(2) of the 1933 Act, 15 U.S.C. § 77d(2), exempts transactions not involving any public offering from the Act's registration provisions, there is no comparable exemption from the antifraud provisions." The "antifraud provisions" involved in *Landreth* were those in the Securities Exchange Act of 1934, not Section 12(2) of the Securities Act of 1933. See 471 U.S. at 684. A companion case to *Landreth Timber,* however, did involve a claim under Section 12(2). *Gould* v. *Ruefenacht,* 471 U.S. 701, 703-704 (1985). *Gould* held, "[f]or the reasons stated in [the Court's] decision" in *Landreth Timber,* that the stock sale in *Gould* involved "securit[ies]" within the meaning of the federal securities laws, notwithstanding the private character of the transaction. *Gould,* 471 U.S. at 704.

The drafters of the Act limited the exemption of the transactions identified in Section 4 to the registration requirements in Section 5 in order to subject those transactions to the private right of action in Section 12(2), as well as to the antifraud provision in Section 17(a), which is enforced by the government. James M. Landis, the Act's principal drafter, see note 8, *supra,* explained that the Section 4 exemptions "are only from Section 5 and not the other provisions of the bill" because:

> Upon section 5 is made to depend practically all the liabilities, whether criminal or civil, that flow from the fact of non-registration or registration. Dealings in securities may, however, be violative of the provisions of the bill, even though they are not related to the fact of registration. (See e.g. Section 12(b) [*sic*; Section 12(2)]; Sect. 16 [Section 17

[13] Section 4(1) exempts "transactions by any person other than an issuer, underwriter, or dealer"; Section 4(3) exempts ordinary trading transactions by a dealer not involving a distribution; and Section 4(4) exempts unsolicited brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market. 15 U.S.C. 77d(1), (3), and (4).

as enacted]; Sect. 18 [incorporating state blue sky laws, deleted before enactment].

James M. Landis, *Reply to Investment Bankers Association Objections of May 5, 1933,* at 5.[14]

2. There is no merit to the view that the structure of the Securities Act shows that Section 12(2) is concerned only with initial public offerings and not private or aftermarket sales, because it is placed after Sections 11 and 12(1), 15 U.S.C. 77k and 77*l*(1), and before Section 13, 15 U.S.C. 77m, and because that cluster of provisions deals only with initial distributions. See *Ballay* v. *Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 691 (3d Cir.), cert. denied, 112 S. Ct. 79 (1991); SIA Amicus Br. 9-10. Section 13 provides the statute of limitations for the private rights of action created in Sections 11 and 12; the issue of whether that provision deals solely with initial public distributions depends on whether Section 12(2) is so limited.

Section 11 (which imposes liability for false or misleading registration statements) was placed adjacent to Section 12 because those provisions contain the Act's only private rights of action. And Section 12(2) was placed in the same section as Section 12(1) (which imposes strict liability for selling securities in violation of the Act's registration requirement) because both create actions against the seller and both share the same remedial provisions (*i.e.*, rescission or, if the security has been sold, damages). The arrangement of those provisions is thus not indicative of any intention to restrict Section 12(2) to initial or public distributions.[15]

[14] Landis collected various intermediate drafts and other materials pertaining to the legislative history of the Act under the title *The Genesis of the 1933 Securities Act* (*Genesis*) (Harvard Law School Library). James M. Landis, *supra,* 28 Geo. Wash. L. Rev. at 29 n.1. Those materials are also collected in volumes in the Commission's library entitled *Legislative History of the Securities Act of 1933, 73d Cong., 1st Sess., 1933,* Vols. I-VI (*SEC Legislative History*). Landis's *Reply* is reproduced in *Genesis,* Item No. 33, and in *SEC Legislative History,* Vol. II, Item No. 3.

[15] Nor does Section 12(2)'s provision of a remedy only for securities purchasers indicate that Congress believed that it was limited to initial public distributions. Pet. Br. 27. The antifraud provision enforced by the government, Section 17 of the Act, is also limited to frauds in the offer or sale of securities, but that provision is clearly applicable to private transactions and aftermarket trading as well as to initial distributions. See *United States* v. *Naftalin, supra.*

C. The Textual Reading Of Section 12(2) Is Supported By The Provision's Legislative Background And Subsequent History

Because the scope of Section 12(2) can be gleaned from the language and structure of the Act, only the clearest legislative history could warrant a departure from that meaning. See, *e.g.*, *National Organization for Women, Inc.* v. *Scheidler,* 114 S. Ct. 798, 806 (1994). In fact, the legislative drafting process that produced Section 12(2) lends further support to the conclusion that the provision does not exempt private or aftermarket transactions. Discussions in committee reports do not contradict that conclusion, and, significantly, both contemporary commentators and agency officials considered Section 12(2) to cover the entire range of securities transactions.

1. *Evolution of Section 12(2).* The drafting history of the Securities Act makes clear that Congress intended Section 12(2) to apply to all types of securities sales, not only to public or initial sales. The bill that eventually became the Securities Act (H.R. 5480, 73d Cong., 1st Sess. (1933)) was drafted in the House.[16] In early drafts of the House bill, the remedy for misrepresentations in a prospectus was included in Section 11 (which applied only to registered securities) and was limited to misrepresentations in a prospectus filed with a registration statement; in addition, private and secondary market sales were generally exempted from the provisions of the Act.[17] A subse-

[16] The first House bill (H.R. 4314, 73d Cong., 1st Sess. (1933)) was the Administration bill, which was introduced simultaneously with President Roosevelt's message to Congress recommending securities legislation. (The message is quoted in H.R. Rep. No. 85, 73d Cong., 1st Sess. 1-2 (1933)). That bill, like its Senate counterpart (S. 875, 73d Cong., 1st Sess. (1933)) expressly provided that the remedy for securities purchasers based on misrepresentations was not applicable in private or aftermarket transactions. Neither of those bills, however, formed the basis for the Securities Act or the Section 12(2) remedy that Congress ultimately enacted. See James M. Landis, *supra,* 28 Geo. Wash. L. Rev. at 30-49; H.R. Conf. Rep. No. 152, 73d Cong., 1st Sess. 24 (1933).

[17] Private and aftermarket sales were not exempted from the antifraud provision enforced by the government. See, *e.g.*, Confidential Committee Print

quent draft of the House bill deleted those limitations on the private remedy for misrepresentations in a prospectus. The drafters removed the buyer's remedy for a false or misleading prospectus from Section 11 and placed it in Section 12, where it was not limited to registered securities. And the drafters narrowed the exemptions in Section 4 (including those for private and aftermarket sales) to become exemptions only from Section 5's registration and prospectus-delivery requirements.[18]

Those simultaneous changes had only one purpose: to make the buyer's remedy that is now Section 12(2) applicable to all types of securities sales. The Investment Bankers Association (IBA), the SIA's predecessor, which had participated actively in commenting on drafts of H.R. 5480, immediately publicized that fact, stating that Section 12(2)

> refers to any sale by anyone in interstate commerce of any security by means of any prospectus, notice, circular, advertisement, letter or communication, written or by radio, or any oral communication. There are no exemptions and no exempted transactions. Every individual, including every private investor, comes under this section.

IBA Memorandum of May 5, 1933, at 5 (emphasis omitted) (*Genesis*, Item No. 32; *SEC Legislative History*, Vol. IV, Item No. 10). The IBA, with others, spearheaded a campaign to convince the House-Senate Conference Committee not to adopt the provisions of the pending legislation on this and other points—a campaign that ultimately failed.[19]

2. *Legislative history*. Particularly in light of that drafting record, the legislative history cannot be read to support petitioners' claim that Section 12(2) has a narrower scope than its language provides. Pet. Br. 35-36; SIA Amicus Br. 14. Petitioners rely on language in a section of the House Report titled "General Analysis," which states:

> The bill affects only new offerings of securities * * *. It does not affect the ordinary redistribution of securities unless such redistribution takes on the characteristics of a new offering by reason of the control of the issuer possessed by those responsible for the offering.

H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933). That statement is an accurate description of the registration provisions of the Act, but it does not capture the bill's full scope. The actual provisions of the bill made the exemptions for secondary trading and private transactions applicable only to the registration requirement—not to the remedy provided in Section 12(2) or to the government antifraud remedy provided in Section 17.[20] See pp. 12-14, *supra*; *United States v. Naftalin*, *supra*. The Committee Report's two-sentence synopsis of the bill is not a substitute for the bill's detailed provisions.

Nor does the House Report's description of the civil liability provisions of the bill provide a sound basis for construing Section 12(2)'s coverage. See Pet. Br. 35 n.13; SIA Amicus Br. 15. The Report states that Sections 11 and 12 apply only to "securities sold upon a registration statement." H.R. Rep. No. 85, *supra*, at 9. That statement is true of Section 11, but the rights of action created under Section 12 also apply expressly to persons who sell securities in transactions that are not registered. The Report further states that liability is restricted to untruths or omissions "in the registration statement or the prospectus." H.R. Rep. No. 85, *supra*, at 9. Section 12(1), however, is not based on misrepresentation at all, and Section 12(2) explicitly applies to misrepresentations in a "prospectus

No. 1, §§ 4(a) and (b), 11(f), 14(b) (Apr. 19, 1933) (*Genesis*, Item No. 5; *SEC Legislative History*, Vol. III, Item No. 1).

[18] See Confidential Committee Print No. 1, §§ 4, 12 (Apr. 21, 1933) (*Genesis*, Item No. 6; *SEC Legislative History*, Vol. III, Item No. 3).

[19] See *I.B.A. Head Hits Securities Bill*, Wall St. J., May 12, 1933, at 4 (statement of IBA President Frank H. Gordon); Letter of May 6, 1933, to IBA membership, with attached Memorandum (*Genesis*, Item No. 32; *SEC Legislative History*, Vol. IV, Items No. 10 (memorandum) and 13 (letter)); see also 77 Cong. Rec. 3801 (1933) (remarks of Sen. Fletcher, the Senate manager of the bill).

[20] Indeed, the report specifically noted, in the general description of the bill following the paragraph quoted in the text, that "[t]he Commission may apply to the courts to enjoin any device, scheme, or artifice to defraud, employed in connection with the sale * * * of any securities, *whether new or already outstanding*." H.R. Rep. No. 85, *supra*, at 6 (emphasis added).

or oral communication."[21] The imprecise language in the House Report's overview of the bill thus underscores that the Report does not control the language of the bill as enacted.[22]

The SIA also relies on the fact that the Senate bill, and its accompanying report, S. Rep. No. 47, 73d Cong., 1st Sess. (1933), contained exemptions that limited the civil remedy for purchasers to initial distributions. SIA Amicus Br. 16-18. The short answer to that contention is that the language of the Senate bill did not form the basis for the Securities Act in general or for Section 12(2) in particular. See note 16, *supra.* And there is no significance to the fact that the conference committee's report, H.R. Conf. Rep. No. 152, 73d Cong., 1st Sess. (1933), did not specifically note that the conferees had adopted the broader coverage provided by the Section 12(2) remedy in the House bill. See SIA Amicus Br. 17-18. As this Court has noted, see *Aaron* v. *SEC,* 446 U.S. 680, 699 n.17 (1980), the Conference Report's stated purpose was to identify differences between "the

[21] Similarly, petitioners (Br. 26) and the SIA (Amicus Br. 15) highlight the Report's explanation for eliminating the reliance requirement in Section 12(2). The Report explained that proof of reliance was unnecessary because "[t]he statements for which [the persons liable] are responsible, although they may never actually have been seen by the prospective purchaser, because of their wide dissemination, determine the market price of the security." H.R. Rep. No. 85, *supra,* at 10. The Act, however, does not impose a requirement of "wide dissemination" in order for a purchaser to sue under Section 12(2), and, in any event, the Report's logic is not limited to registration statements. Many representations made in connection with secondary trading also receive wide dissemination and affect the market price of a security. See *Basic Inc.* v. *Levinson,* 485 U.S. 224, 246 (1988).

[22] The SIA notes that several Members of Congress pointed out that the Securities Act would not provide full protection for investors in post-distribution securities trading and that further legislation was needed. SIA Amicus Br. 15-16. Those comments provide no basis for concluding that Section 12(2) does not reach securities sales beyond the distribution context. Congress did enact comprehensive legislation governing the secondary markets in the Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq.*, and it is farfetched to infer that because legislators saw the need for that detailed regulatory scheme (which, among other things, created the SEC as a specialized agency to enforce the securities laws), they must have believed that the private right of action in Section 12(2) did not apply to the secondary markets.

House bill and the substitute agreed upon by the conferees." H.R. Conf. Rep. No. 152, *supra,* at 24.

3. *Subsequent interpretations.* Significantly, commentators in the months immediately following the enactment of the Securities Act noted that the Section 12(2) remedy applies to all types of securities sales. William O. Douglas, who was later to serve as a Chairman of the Commission, co-authored an influential and comprehensive review of the Act, which repeatedly recognized that Section 12(2) is not limited to initial or public transactions.[23] Other persons who were deeply involved in the drafting and implementation of the Act also expressed the view, at the time of its enactment and afterwards, that Section 12(2) applies to aftermarket transactions.

One week after the Securities Act was signed into law, the Federal Trade Commission (FTC), which was initially charged with enforcing the Act, issued a release explaining the effective dates of various provisions of the Act. The release states that both Sections 12(2) and 17(a) "apply to outstanding securities as well as to new issues which are to be placed in the market after registration." *Effective Dates of Securities Act of 1933 Are Explained,* Securities Act of 1933, Rel. No. 3, 1933 SEC LEXIS 8, at *2 (June 2, 1933). A few months later, in its release of the rule governing advertising of securities, the FTC reiterated that Section 12(2) applied to securities that were outstanding before the effective date of the Act, even though those securities were not required to be registered:

> The rule applies only to the advertising of securities which are or should be registered under the Act. Those securities which were sold or offered before July 27 of this year may, therefore, continue to be advertised in any form,

[23] William O. Douglas & George E. Bates, *The Federal Securities Act of 1933,* 43 Yale L.J. 171, 183 (1933) (noting that, except for transactions in securities exempt under Section 3(a)(2), no securities or transactions are exempt from Section 12(2)); *id.* at 189-190 (Section 12(2) applies to "every written communication or advertisement offering a security for sale," not only to prospectuses meeting the requirements of Section 10); *id.* at 207-209 (brokers can be liable under Section 12(2) for sales that are not part of an initial distribution).

subject only to the limitations of Sections 12(2) and 17 imposing civil and criminal liability for material misstatements and omissions.

Securities Act of 1933, Rel. No. 54, 1933 SEC LEXIS 59, at *1-*2 (Oct. 13, 1933) (emphasis added).

Similarly, within months of the Act's passage, Arthur Dean, who had consulted closely with the House Commerce Committee during the drafting process, and then-Professor Felix Frankfurter, the organizer of the team that drafted the Act, published articles describing the Act. Dean unequivocally stated that Section 12(2) applies to ordinary market trading as well as to initial public distributions.[24] Likewise, Professor Frankfurter stated that the Act "seeks to terminate the facilities of the mails and of interstate commerce for dishonest or unfair dealings in the sale of all private or foreign government securities, new or old. If any person makes an untrue statement of a material fact or omits to state a fact without which the facts stated would really be misleading, he is subject to a suit for rescission or damages." Felix Frankfurter, *The Federal Securities Act: II*, 8 Fortune 53, 108 (1933). Critics of the Act concurred with that view. Soon after the Act became law, calls went out for its amendment, particularly with respect to its civil liability provisions. Those urging the Act's amendment consistently recognized that Section 12(2) applies to market transactions.[25]

[24] Dean, who was counsel for the Investment Bankers Association, wrote that Section 12(2) covers "anyone selling any security including outstanding securities, registered securities, or securities exempt from registration * * *, by means of a prospectus or oral communication" that includes a material misrepresentation. Arthur Dean, *The Federal Securities Act: I*, 8 Fortune 50, 102 (1933). After the Act was amended in 1934, Dean wrote another article explaining the revised Act, He reiterated that Section 12(2) imposes liability "on everyone whether Banker Rich or Widow Poor who sells a security by means of a prospectus or oral communication that misstates or omits material facts in the light of the circumstances under which the statements are made." Arthur Dean, *As Amended: The Federal Securities Act*, 10 Fortune 80, 81 (1934).

[25] For example, an American Bar Association committee recommended placing a duty of reasonable care on the plaintiff because Section 12(2) "is not confined to those sellers who have special sources of information but applies

The comprehensive coverage of Section 12(2) sparked later proposals to amend the Act as well. In 1941, in discussing a proposal that enjoyed both industry and SEC support, both the Commission and industry representatives stated that Section 12(2) applies to market transactions.[26] SEC Commissioner Ganson Purcell reaffirmed that view later in 1941 when he informed a House committee of a joint recommendation by the Commission and industry representatives to amend Section 12(2) in order to tailor its requirement of reasonable care to the varied types of transactions it covers. Commissioner Purcell noted that Section 12(2) "is very important in the daily routine of the security business," because it applies "to statements made in the formal prospectus required by the Securities Act"; "to state-

to all sellers of securities." *Report of the Special Committee on Amendments to the Securities Act of 1933*, 59 Rep. A.B.A. 565, 578 (1934). Similarly, the Committee on Securities Regulation of the Chamber of Commerce of the United States also understood that "any person, even one acting in a private capacity, who *sells* a security—that is not specifically exempted by the Act—either in interstate commerce or by the use of the mails by means of a prospectus or oral communication" containing a materially misleading representation is liable to the purchaser. Congressional Digest, *Should the Federal Securities Act of 1933 be Modified?* 136, 138 (May 1934), quoting *Report of the Committee on Securities Regulation of the Chamber of Commerce of the United States* (Mar. 1934).

[26] See, *e.g.*, Staff of House Comm. on Interstate and Foreign Commerce, 77th Cong., 1st Sess., *Report of the Securities and Exchange Commission on the Proposals for Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934*, at 14 (Comm. Print 1941) ("Section 12(2) of the act permits a purchaser to recover from a person who has sold securities to him on the basis of untrue statements or misleading omissions. It does not distinguish between sellers engaged in a distribution subject to registration and those selling outstanding securities."); Investment Bankers Association of America *et al.*, *Report on the Conferences with the Securities and Exchange Commission and its Staff on Proposals for Amending the Securities Act of 1933 and the Securities Exchange Act of 1934*, at xi, 149 (1941) (Section 12(2) does not differentiate among "the several situations in which securities are sold"; it applies both to new securities subject to the registration process and "to statements made by brokers seeking to execute customers' orders to sell" where "the security is an outstanding security not subject to those information requirements"; and Section 12(2) perhaps applies as well to "statements made by brokers in the solicitation from their customers of orders to buy").

ments by individual private owners in disposing of their securities"; and "to brokers who sell securities on behalf of their customers."[27]

With few exceptions, commentators have also expressed the view that Section 12(2) is not limited to initial distributions to the public.[28] Courts have also universally applied Section 12(2) to private transactions; and until quite recently, no court had refused to apply the provision to secondary market transactions.[29]

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[27] *Proposed Amendments to the Securities Act of 1933 and to the Securities Exchange Act of 1934: Hearings on H.R. 4344, H.R. 5065, and H.R. 5832 Before the House Comm. on Interstate and Foreign Commerce*, 77th Cong., 1st Sess. Pt. 1, at 806-807 (1941) (Joint Statement of SEC and Industry Representatives, presented by Commissioner Purcell).

[28] Professor Louis Loss early voiced that view, and has consistently adhered to it. See, *e.g.*, Louis Loss, *Securities Regulation* 996-997, 1006-1008 (1951); 3 Louis Loss, *Securities Regulation* 1699, 1712 n.89 (1961); 9 Louis Loss & Joel Seligman, *Securities Regulation*, 4217-4222 (3d ed. 1992). Other treatise writers agree. See 3A Harold Bloomenthal, *Securities and Federal Corporate Law* § 8.05[3], at 8-43 to 8-44.8 (1993); 2 Alan Bromberg & Louis Lowenfels, *Securities Fraud and Commodities Fraud* § 5.2, at 600 (1992); 1 Thomas Hazen, *The Law of Securities Regulation* § 7.5, at 318 (2d ed. 1990); 17A J. William Hicks, *Civil Liabilities: Enforcement and Litigation Under the 1933 Act* § 6.01[3], at 6-12 to 6-39 (1993). Several recent articles reach the same conclusion. See Therese Maynard, *Section 12(2) of the Securities Act of 1933: A Remedy for Fraudulent Postdistribution Trading?*, 20 Sec. Reg. L.J. 152 (1992); Comment, *Applying Section 12(2) of the 1933 Securities Act to the Aftermarket*, 57 U. Chi. L. Rev. 955 (1990); Robert Rapp, *The Proper Role of Securities Act Section 12(2) as an Aftermarket Remedy for Disclosure Violations*, 47 Bus. Law. 711 (1992). Contrary views have been expressed by Elliot Weiss, *The Courts Have It Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 Bus. Law. 1 (1992), and Robert Prentice, *Section 12(2): A Remedy for Wrongs in the Secondary Market?*, 55 Alb. L. Rev. 97 (1991). Professor Weiss is apparently the only commentator to suggest that Section 12(2) does not apply to private transactions.

[29] Every court that has considered the issue has ruled that private placements are subject to Section 12(2), even though such placements need not be registered. See *Pacific Dunlop Holdings, Inc.* v. *Allen & Co.*, 993 F.2d 578, 587 (7th Cir. 1993), cert. granted, 114 S. Ct. 907, cert. dismissed, 114 S. Ct. 1146 (1994); *Metromedia Co.* v. *Fugazy*, 983 F.2d 350, 360 (2d Cir. 1992), cert. denied, 113 S. Ct. 2445 (1993); *Haralson* v. *E.F. Hutton Group, Inc.*, 919 F.2d 1014, 1032 (5th Cir. 1990); *Nor-Tex Agencies, Inc.* v. *Jones*, 482 F.2d

These long held views on the scope and coverage of the Act by scholars, securities practitioners, and the agency charged with its enforcement are entitled to considerable weight.

D. Policy Considerations Provide No Basis For A Narrow Application Of Section 12(2)

Although petitioners rely heavily on policy arguments, this Court has declined to permit the general purposes and policies of the federal securities law to override the language of specific provisions. See *Central Bank of Denver* v. *First Interstate Bank of Denver*, 114 S. Ct. 1439, 1453-1454 (1994); *Pinter* v. *Dahl*, 486 U.S. at 654. In any event, rather than suggesting that Section 12(2) should be found altogether inapplicable to private or secondary market securities sales, policy considerations reinforce the longstanding interpretation of the provision.

One of the central purposes of the federal securities laws was to remedy perceived deficiencies in the common law. *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 389 (1983). Section 12(2) serves that purpose by providing securities purchasers injured by the seller's misrepresentations or misleading statements

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1093, 1099 (5th Cir. 1973), cert. denied, 415 U.S. 977 (1974); *Woodward* v. *Wright*, 266 F.2d 108, 116 (10th Cir. 1959); *Pawgan* v. *Silverstein*, 265 F. Supp. 898, 900 (S.D.N.Y. 1967). See also *Wright* v. *National Warranty Co.*, 953 F.2d 256, 259-261, 262 (6th Cir. 1992) (Section 12(2) action for misrepresentation in private placement); *Adalman* v. *Baker, Watts & Co.*, 807 F.2d 359 (4th Cir. 1986) (same). Petitioners' claim that there is a conflict in the courts of appeals on whether Section 12(2) applies to private sales is incorrect.

On the other hand, there is a split of authority on whether secondary market transactions are covered. While it appeared unquestioned that Section 12(2) covered secondary market trading when the Court decided *Wilko* v. *Swan*, 346 U.S. 427 (1953) (predispute arbitration clause does not bar a judicial action under Section 12(2) by a customer against a broker), and the view continued to be prevalent as of *Rodriguez de Quijas* v. *Shearson/American Express, Inc.*, 490 U.S. 477 (1989) (overruling *Wilko* and enforcing arbitration clause covering Section 12(2) claim against a broker), the Third and the Eleventh Circuits have recently held that Section 12(2) is inapplicable to secondary trading. *Ballay* v. *Legg Mason Wood Walker, Inc.*, *supra*; *First Union Discount Brokerage Services, Inc.* v. *Milos*, 997 F.2d 835, 842-843 (11th Cir. 1993). The Seventh Circuit reached the contrary conclusion in *Pacific Dunlop*, *supra*.

with a federal cause of action, in which the purchaser need not show reliance and the seller must establish that he did not know and in the exercise of reasonable care could not have known of the misstatement or omission.[30] None of the other express remedies in the Securities Act or the Securities Exchange Act of 1934 provides a private cause of action for misstatements in the sale of securities in private or secondary market sales.[31] Because one of Congress's primary focuses in enacting the federal securities laws was the "need for regulation to prevent fraud and to protect the interest of investors," *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 849 (1975), it is "almost inconceivable" that Congress failed to provide a private remedy for investors based on misstatements in the sale of securities in market transactions.[32] 9 Louis Loss & Joel Seligman, *Securities Regulation* 4220 (3d ed. 1992).

[30] Petitioners err, however, in suggesting (Br. 8, 27-28) that Section 12(2) worked a radical change in the common law obligations a seller owed a buyer or turned every seller into a fiduciary. At common law, rescission was available for innocent material misrepresentations, and an action for deceit was available in some jurisdictions to remedy even negligent misrepresentations. See generally 7 Louis Loss & Joel Seligman, *Securities Regulation* 3421-3424 (3d ed. 1991); 9 *id.* at 4125-4128, 4197-4207. For a contemporaneous review of the common law remedies and Section 12(2)'s relationship to them, see Harry Shulman, *Civil Liability and the Securities Act*, 43 Yale L.J. 227 (1933).

[31] Section 11 of the Securities Act, 15 U.S.C. 77k, applies to misstatements and omissions in a registration statement. Section 9(e) of the Exchange Act, 15 U.S.C. 78i(e), creates a right of action in favor of investors affected by manipulation on a national securities exchange against any person who willfully participates in proscribed acts. Section 18(a) of the Exchange Act, 15 U.S.C. 78r(a), creates a right of action in favor of investors affected by false or misleading statements, made in bad faith, in filings with the Commission.

[32] The implied cause of action under Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b), and Rule 10b-5 of the Commission, 17 C.F.R. 240.10b-5, does apply to fraud in private and aftermarket sales of securities. That implied remedy was not recognized until 1946, however, and this Court has "made no pretense that it was Congress' design to provide the remedy afforded." *Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson*, 111 S. Ct. 2773, 2779, 2780 (1991); see *Musick, Peeler & Garrett* v. *Employers Insurance of Wausau*, 113 S. Ct. 2085, 2088-2089 (1993). Contrary to petitioners and the SIA's assertions

Petitioners and the SIA raise policy concerns about the application of Section 12(2) to the private transaction at issue in this case.[33] According to petitioners, Section 12(2) protection is unnecessary (and counterproductive) in private transactions because the buyers in such transactions can protect their interests through negotiated terms. Pet. Br. 38-41; SIA Amicus Br. 26-29. In some private placements, however, the transaction is offered through a prepared selling document and there are no negotiations between buyer and seller.[34] Yet there is no evidence that Congress intended some private sales to be subject to Section 12(2) and others not, based on whether the parties engaged in negotiations. Rather, Congress's response to the special nature of private transactions was to exempt private placements from registration; it was not to withdraw a purchaser's right to rescind a transaction tainted by false or misleading statements.

The SIA also raises policy concerns about application of Section 12(2) to ordinary trading in the public securities markets. Amicus Br. 18-26. As noted above, in 1941 the Commission expressed somewhat similar concerns about the appropriate standard of liability to be used in secondary market transactions, and it proposed legislative amendments to Section 12(2) to address that issue. The Commission and the industry agreed at that time that the answer to those policy concerns was not to eliminate Section 12(2) liability for secondary market transactions.

(Pet. Br. 8, 32; SIA Amicus Br. 3 n.3), the existence of the implied cause of action under Section 10(b) therefore sheds no light on Congress's intentions with respect to the scope of Section 12(2).

[33] The dissent in *Landreth Timber* advanced similar policy arguments in opposing the view that the sale of all of a company's stock in a private transaction is a sale of securities. *Landreth Timber Co.* v. *Landreth*, 471 U.S. at 697-700 (dissenting opinion). This Court, however, see *id.* at 694 n.7, declined to rely on those policy considerations to cut back on the coverage of the statutory language.

[34] That has been increasingly the case since the SEC's adoption in April 1990 of Rule 144A, 17 C.F.R. 230.144A, relating to private resales of securities to institutions. See Robert F. Quaintance, Jr., *Getting Comfortable with "Public-Style" Rule 144A Offerings*, Insights, at 8 (Sept. 1993). The protections of Section 12(2) are particularly important in those transactions.

Rather, it was to clarify the proper application of the reasonable care defense. See note 27, *supra,* and accompanying text. The Commission is now exploring possible regulatory action, including clarification of what constitutes reasonable care under the circumstances. The responsibility for remedying any flaws in Section 12(2) lies with Congress and the Commission; the courts may not rewrite the provision to temper effects of its clear language.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

DREW S. DAYS, III
Solicitor General
EDWIN S. KNEEDLER
Deputy Solicitor General
MICHAEL R. DREEBEN
Assistant to the Solicitor General

SIMON M. LORNE
General Counsel
PAUL GONSON
Solicitor
JACOB H. STILLMAN
Associate General Counsel
BRIAN D. BELLARDO
Assistant General Counsel
MARK PENNINGTON
Special Counsel
Securities and Exchange Commission

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APPENDIX

Section 2(10) of the Securities Act of 1933, 15 U.S.C. 77b(10), provides:

[U]nless the context otherwise requires—* * * [t]he term "prospectus" means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security, except that

(a) a communication sent or given after the effective date of the registration statement (other than a prospectus permitted under subsection (b) of [Section 10]) shall not be deemed a prospectus if it is proved that prior to or at the same time with such communication a written prospectus meeting the requirements of subsection (a) of [Section 10] at the time of such communication was sent or given to the person to whom the communication was made, and

(b) a notice, circular, advertisement, letter, or communication in respect of a security shall not be deemed to be a prospectus if it states from whom a written prospectus meeting the requirements of [Section 10] may be obtained and, in addition, does no more than identify the security, state the price thereof, state by whom orders will be executed, and contain such other information as the Commission, by rules or regulations deemed necessary or appropriate in the public interest and for the protection of investors, and subject to such terms and conditions as may be prescribed therein, may permit.

Section 12(2) of the Securities Act of 1933, 15 U.S.C. 77*l*(2), provides:

Any person who—* * * offers or sells a security (whether or not exempted by the provisions of [Section 3], other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or com-

munication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

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No. 93-404

IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

ARTHUR L. GUSTAFSON, DANIEL R. McLEAN
and FRANCIS I. BUTLER,
Petitioners,

v.

ALLOYD, CO., INC., and
WIND POINT PARTNERS II, L.P.,
Respondents.

**On Writ of Certiorari
To The United States Court of Appeals
For The Seventh Circuit**

BRIEF OF *AMICUS CURIAE* NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC. IN SUPPORT OF RESPONDENTS

KAREN M. O'BRIEN
General Counsel
North American Securities
Administrators Association, Inc.
One Massachusetts Avenue, N.W.
Washington, D.C. 20001
(202) 737-0900

CASILLAS PRESS INC. - 1717 K STREET NW WASHINGTON DC 20036 – 223-1220

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QUESTION PRESENTED

Whether the private cause of action against sellers of securities created by Section 12(2) of the Securities Act of 1933 is limited to initial public distributions.

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AUTHORITY TO FILE AND POSITION OF AMICUS CURIAE

This brief is filed pursuant to Rule 37.3 of the Rules of this Court. The parties consent letters have been filed with the Clerk of this Court. This brief supports the position of the respondents.

STATEMENT OF INTEREST OF AMICUS CURIAE

The North American Securities Administrators Association, Inc. ("NASAA") serves as the forum where its members, the securities regulators of the fifty states, the District of Columbia, Puerto Rico, the Canadian provinces and territories and the Republic of Mexico ("NASAA Members") work together to protect investors at the grassroots level and to promote fair and open capital markets. NASAA speaks as the collective voice for its Members in forwarding those interests.

The principal interest of NASAA in the present case is to seek uniformity in the interpretation of state and federal securities law provisions that are, for the most part, mirror images of each other. Section 410(a)(2) of the Uniform Securities Act of 1956 (the "Uniform Act"), the language of which is very similar to Section 12(2) of the Securities Act of 1933 (the "1933 Act"), has been consistently interpreted to grant a private cause of action against all sellers who make offers or sales of securities (even in the secondary market) that include an untrue statement of a material fact or a material omission. The federal courts, however, interpreting the language of Section 12(2), are split on this issue; some have extended liability only to initial public offerings and others have held that the liability extends to secondary market transactions.

Recognizing that the states and the SEC have been granted joint regulatory authority over the securities markets in the United States, the state and federal courts should seek to interpret these parallel state and federal securities provisions uniformly. Uniform, or similar interpretations, will send a clear message to the marketplace of what is expected and accepted behavior in the securities markets and will assist regulators in the enforcement of the securities laws. Furthermore, a

uniform interpretation of these parallel provisions will promote judicial economy in the state and federal court systems.

As a strong advocate for the protection of the small investor, NASAA is also concerned that a narrow interpretation of Section 12(2) will place small investors at a disadvantage in the marketplace. The small investor generally does not have the same access to information as do large institutional investors or insiders who may demand informtion from an issuer or a market maker, regardless of whether such information is required to be provided. Therefore, it is important that the civil liability imposed under Section 12(2) be held to extend to all secondary market transactions in order to promote the delivery of accurate information to all who participate in the marketplace, at all entry levels. Moreover, contrary to what some may like us to believe, the extension of civil liability under Section 12(2) to secondary market transactions will not create any undue hardships on persons selling securities to perform extensive due diligence. A broad interpretation of Section 12(2) will merely require that all sellers of securities, based upon their knowledge and circumstances, provide accurate information to purchasers.

As previously stated, NASAA is interested in the promotion of fair and open capital markets. NASAA is filing this brief not only to emphasize to the Court the need for uniform treatment of parallel state and federal laws, but also to encourage the Court to promote good public policy by interpreting Section 12(2) to extend to private resale securities transactions as well as to the public distribution of securities.

SUMMARY OF ARGUMENT

The issue before the Court today is whether Section 12(2) creates a cause of action in favor of a purchaser of securities against any "person" who sells "by means of a prospectus

or oral communication" that contains a material misrepresentation or an omission that renders the statements misleading. To determine the scope of Section 12(2), the Section as a whole must be examined, as well as all of its parts, and only if there is confusion should one look at the legislative history of the Section and the policy considerations.

When one looks at the interplay in Section 12(2) between the defined terms "person" and "prospectus," the scope of the Section becomes clear. Congress' choice of the word "person," rather than "issuer," for the introductory clause to the Section suggests the breadth of the Section's application. The inclusion of the word "prospectus" and its use in the alternative to the phrase "oral communication" further clarifies the application of the Section. Looking at the broad definition of the word "prospectus" in Section 2(10) and the fact that the term "prospectus" in Section 12(2) is linked so closely with the broad phrase "oral communication," a narrow interpretation of the term "prospectus" in Section 12(2) would seem contradictory.

Word games are not necessary. The plain meaning of Section 12(2) states that any person who sells a security using a written document or oral communication that contains a material misstatement or omission shall be liable to the person purchasing the security. The Section does not say "only if the purchaser is purchasing from an issuer directly." The civil liability of the Section must extend to secondary trading activity.

Although the plain wording of the Section is clear, if one chooses to look to the legislative history of Section 12(2), it is hard to imagine that Congress enacted legislation to protect only some purchasers of securities. Section 12(2) needs to have broad application to satisfy Congress' attempt to bring confidence back to the marketplace.

Moreover, in order to promote efficient and effective securities regulation, parallel state and federal securities provisions should be interpreted uniformly. The similarity of the language of Section 12(2) of the 1933 Act and Section 410(a)(2) of the Uniform Act is striking. By interpreting them the same, fairness and judicial economy will exist in the marketplace. If, however, this Court chooses to interpret Section 12(2) differently than the state courts have interpreted Section 410(a)(2), the result will be forum shopping, inconsistent investor protection at the state and federal levels and confusion in the marketplace.

Finally, the extension of Section 12(2) to the trading markets will not have a draconian effect on the current practices of securities firms and analysts. Although the federal courts are not uniformly behind the extension of liability to aftermarket activity under Section 12(2), some federal courts and the state courts currently apply civil liability to the secondary markets under Sections 12(2) of the 1933 Act and 410(a)(2) of the Uniform Act, and a "chilling effect" has not occurred. Moreover, securities firms and their agents are otherwise required to review their communications to the public under the NASD's Rules of Fair Practice .

The only valid interpretation of Section 12(2) extends the civil liability of the Section to all sellers, regardless of their status, who make material misrepresenations or omissions in written or oral communications used in the sale of securities.

ARGUMENT

At issue before the Court today is the scope of the civil liability imposed on sellers of securities under Section 12(2) of the 1933 Act when using a "prospectus or an oral communication" that includes an untrue statement of a material fact or

an omission of a material fact. 15 U.S.C. §77l(2)[1] That a private cause of action exists under Section 12(2) is not disputed by the experts.[2] What has not been resolved, however, is whether liability applies only when untrue statements or omissions are included in a "prospectus" used in the sale of securities in conjunction with a public offering or whether liability exists for private offerings of securities as well.[3] Moreover, this debate has also been framed by arguments that the civil liability of Section 12(2) applies only to issuer offerings and does not apply to secondary offerings.[4] As the Court most likely realizes, these debates are not mutually exclusive.

To settle this debate and determine the intent of Section 12(2), one must closely examine the wording of the Section. Fundamental to the wording of the Section, and key to discovering its intent, is the inclusion of the words "person" and "prospectus," both of which are defined terms under the 1933 Act. The breadth of these definitions and the interplay of these terms in the Section demonstrate Congress' intent to provide extensive civil liability under Section 12(2).

Moreover, in order to fulfill the public policy reasons behind

[1]The text of Section 12(2) is set forth in the Appendix to this brief.

[2]Silverstein, *Seller Liability Under Section 12(2) of the Securities Act of 1933: A Proximate Cause-Substantial Factor Approach Limited by a Duty of Inquiry*, 36 VAND. L. REV. 361 (1983); Peterson, *Recent Developments in Civil Liability Under Section 12(2) of the Securities Act of 1933*,5 HOUS. L. REV. 274 (1967); Rapp, *The Proper Role of Securities Act Section 12(2) as an Aftermarket Remedy for Disclosure Violations*, 47 BUS. LAW. 711 (1992).

[3]Weiss, *The Courts Have it Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 BUS. LAW. 1, 4 (1992).

[4]Loss, *Securities Act Section 12(2): A Rebuttal*, 48 BUS. LAW. 47 (1992).

the enactment of the 1933 Act[5], Section 12(2) must be read to impose civil liability on all sellers of securities for material misrepresentations or omissions included in a prospectus or oral communication, whether used in conjunction with a public distribution of newly issued securities or as part of a private resale of securities.

I. CONGRESS' CHOICE OF WORDS FOR THE INTRODUCTORY CLAUSE TO SECTION 12(2) EVIDENCES ITS INTENTION TO EXTEND TO SECONDARY MARKET TRANSACTIONS THE CIVIL LIABILITY IMPOSED UPON SELLERS BY THE SECTION. THE SECTION READS "ANY PERSON (EMPHASIS ADDED) WHO -", NOT ANY ISSUER WHO -.

One need not read far into Section 12(2) before it becomes obvious that Congress intended the Section to have broad application. The Section begins with the introductory clause, "Any person (emphasis added) who -." The choice of the word "person" in the introductory clause to the Section sends a clear signal regarding Congress' intent for the Section and qualifies the remaining language in the Section.

The term "person" is a defined term in the 1933 Act and references both individuals and entities, creating a broad ap-

[5]Although the focus of the 1933 Act is the initial distribution of securities, "[T]he dominant purpose of the Securities Act is to provide information to purchasers of securities." Rapp, *The Proper Role of Securities Act Section 12(2) As an Aftermarket Remedy for Disclosure Violations*, 47 BUS LAW. 711, 720 (1992). As Rapp noted, "[T]he economic tragedies associated with the issuance of worthless securities" in the decade following World War I were '. . . blamed primarily on underwriters and dealers (emphasis added) who abandoned standards of fair and honest dealing, and who made promises of wealth with little or no attempt to provide information to investors essential to estimating the worth of a security.' *Id.* citing from H.R. Rep. No. 85, 73rd Cong., 1st Sess. 5 (1933).

plication for any provision in which it is used. §2(2), 15 U.S.C. §77b(2). The 1933 Act also includes a definition of the term "issuer" which, in pertinent part, reads "every person who issues or proposes to issue any security" §2(4), 15 U.S.C. §77b(4). By including a definitional section in the 1933 Act, Congress meant to give specific and clear meaning to particular terms used in the provisions of the Act, thus clarifying their application. Therefore, the definitional section of the 1933 Act should be referenced when attempting to interpret any provision of the Act and, if a defined term has been included in a provision, the term should be interpreted as defined, "unless the context [of the provision] otherwise requires" (emphasis added). §2, 15 U.S.C. §77b.

If, as the petitioners would like us to believe, Section 12(2) is to apply only to initial public offerings of securities, why would Congress not have selected the word "issuer" instead of "person" for the introductory clause? The use of the term "issuer" would have at least made clear that the Section imposes civil liability only upon sellers who make material misstatements or omissions in conjunction with an initial distribution of securities, whether public or private. Congress used such limiting language in Section 11(b) of the 1933 Act which reads, in pertinent part, "...no person, other than the issuer, shall be liable...." 15 U.S.C. §77k(b). But Congress chose not to so limit the application of Section 12(2).

Moreover, the use of the term "person," as opposed to the term "issuer," is also instructional regarding the meaning of the term "prospectus" included later in the Section. Once again, "unless the context otherwise requires," one should look to the definitional section of the Act for the meaning of terms that have been defined. As set forth in Section 2(10) of the Act, the definition of the term "prospectus" includes such diverse written communications as any "letter,"

"circular" or "prospectus." The reason for the comprehensiveness of this definition becomes evident when it is read in the context of Section 12(2). By using the term "person" to qualify the remainder of Section 12(2), it becomes apparent that the broad definition of the term "prospectus" was meant to extend the application of Section 12(2) to written communications used by individual persons trading securities, as well as written communications used by issuers in the distribution of securities.

II. THE PLAIN MEANING OF THE TERM "PROSPECTUS" SHOULD BE GLEANED FROM ITS DEFINITION AND FROM THE CONTEXT IN WHICH IT IS INCLUDED IN THE ACT.

There is some argument whether the term "prospectus," as included in Section 12(2), should be interpreted consistent with the definition of that same term as set forth by Congress in Section 2(10)[6] of the same Act, or whether the Court should reach beyond the definitional section and apply another more limited meaning to the word "prospectus." Some, who would have Section 12(2) apply only to initial public offerings, appear to believe that the term "prospectus" only refers to a §10(a) or statutory prospectus.[7]

Unless there is a clear reason why a different meaning should be applied, or as the Act states, "unless the context otherwise requires (emphasis added)" the term "prospectus"

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[6]The full text of Section 2(10) is set out in the Appendix to this brief.

[7]*See*, Brief of Amicus Curiae Securities Industry Association, Inc. in Support of Petitioners Alloyd Co., Inc. and Wind Point Partners II, L.P. at 4-9.

should be interpreted as defined.[8] A plain reading of Section 12(2) does not suggest that the term "prospectus," as included therein, requires a different meaning than as defined in Section 2(10). 15 U.S.C. 77b(10). When Section 12(2) is read replacing the term "prospectus" with its definition, the meaning of the Section does not become illogical or confused.

Moreover, *Webster's New World Dictionary* defines the word "require" to mean "to be in need of; to call for as necessary or appropriate; to demand by virtue of a law, regulation, etc." *Id.* (3d College ed. 1988) at 1140. The inclusion of the term "prospectus" in Section 12(2) does not "call for as necessary" a different meaning of prospectus than its definition in Section 2(10). Nor is a different meaning "demanded by virtue of a law, regulation." In fact, traditional rules of draftsmanship and the Act itself, by defining the term "prospectus," demand that the term be interpreted as defined.

Furthermore, unlike the need for this Court in *Ernst & Ernst v. Hochfelder*[9] to turn to contemporary reference works to construe the terms "manipulative or deceptive" and "device or

[8]Section 2 of the 1933 Act sets forth the definitions of certain terms used throughout the Act. As the language of the introductory clause to Section 2 (set out below) demonstrates, deference should be given to these definitions when interpreting those terms as included in the Act, subject to contextual inconsistencies.

Sec. 2. When used in this title [the Securities Act of 1933], unless the context (emphasis added) otherwise requires —

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(10) the term "prospectus" means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security. . . "

[9]425 U.S. 185 (1976).

contrivance"[10] as used in Section 10(b) of the Exchange Act of 1934, because those terms are *not* defined in the 1934 Act itself, there is no need for this Court to look beyond the 1933 Act to determine what is meant by the term "prospectus."

However, the limiting factor of the word "context" in Section 2 is also at issue. It is clear that the phrase "unless the context (emphasis added) otherwise requires," included as the introductory clause to Section 2, was intended to qualify the use of the definitions included in the Section. The question becomes, what is meant by the word "context?" It has been argued that the sections surrounding Section 12(2) should determine whether the definition of "prospectus" in Section 2 is the appropriate definition for the term as included in Section 12(2).[11] We question the need to go beyond the "context" of the sentence where the term is used, or, at most, the Section, neither of which require a different meaning of the term "prospectus."

Similar to the "context" qualification of Section 2, this Court, in *Jarecki v. G.D. Searle & Co.*, 367 U.S. 303 (1961) referred to the maxim *noscitur a sociis*, meaning that a word is known by the company it keeps.[12] Applying that maxim to the

[10]The Court relied on *Webster's New Int'l Dictionary of the English Language* (2d ed. 1934). *Id.*, at 198-99.

[11]*See*, Brief of Amicus Curiae Securities Industry Association, Inc. in Support of Petitioners Alloyd Co., Inc. and Wind Point Partners II, L.P. at 9-10.

[12]In *Jarecki*, the Court stated "The maxim *noscitur a sociis*, that a word is known by the company it keeps, while not an inescapable rule, is often wisely applied where a word is capable of many meanings in order to avoid the giving of unintended breadth to the Acts of Congress." *Id.*, at 307, quoted in *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 687 (3d Cir. 1991). Although the possible number of meanings of the term "prospectus" is very limited, the application of the maxim *noscitur a sociis* to the use of the term in Section 12(2) clarifies that the term "prospectus" means any written communication used in the sale of securities.

independent phrase "by means of a prospectus or oral communication" included in Section 12(2), the words "oral communication" take on significance in determining the meaning of the word "prospectus."

The plain meaning of the phrase "oral communication" is a communication by mouth. The fact that those words are linked in the alternative to the term "prospectus" suggests that the word "prospectus" in Section 12(2) was meant to cover written communications used in the sale of securities. Moreover, neither the word "prospectus" nor the phrase "oral communication" are qualified in Section 12(2), thus leading us to the conclusion that "by means of a prospectus or oral communication" was meant cover all oral and written communications used in the sale of securities. This expansive interpretation of term "prospectus," as included in Section 12(2), is consistent with the broad definition of "prospectus" in Section 2(10), which lists a diverse spectrum of written communication devices, suggesting that the interpretation of the term "prospectus," as included in Sections 2(10) and 12(2) of the 1933 Act, should be one in the same.

III. CONGRESS WAS NOT SO SHORT-SIGHTED SO AS TO LIMIT THE APPLICATION OF THE 1933 ACT SOLELY TO INITIAL PUBLIC OFFERINGS. RATHER, SECTIONS 12 AND 17, AND THEIR APPLICATION TO THE AFTERMARKET, PROVIDED ADVANCE NOTICE OF WHAT WAS ABOUT TO COME.

It has been argued that because Congress adopted the 1933 Act, and thereafter separately adopted the 1934 Act, that Congress had no reason to extend the application of the 1933 Act to aftermarket activity and, instead, limited each Act to deal solely with the initial distribution of securities or with aftermarket activity.[13] We know, however, that this is not true. This Court has held that Section 17 of the 1933 Act,[14] 15 U.S.C. §77q, applies to the aftermarket.[15] Why then should we stretch the plain meaning of Section 12(2) of the Act to avoid its application to secondary market activity? We should not.

As noted by Judge Abner J. Midva in *Wachovia Bank & Trust Co. v. National Student Marketing Corp.*, 650 F.2d 342 (D.C. Cir. 1980):

> [O]verlap between the two statutes [1933 and 1934 Acts] is neither 'unusual nor unfortunate.' *United States v. National Securities, Inc.*, 393 U.S. 453, 468 (1969), quoted in *United States v. Naftalin*, 441 U.S. 768, 778 (1979). It is nowhere written that each pronouncement of Congress must be mutually exclusive of every other pronouncement. In the securities field, Congress has dealt with the problems of regulation many times — on both the cosmic and the specific levels. The 1933 and 1934 Acts are meant to be interrelated and interdependent components of a general scheme, and the two should be read together. *See, Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206 (1976).

1 A. Bromberg & L. Lowenfels, *Securities Fraud & Commodities Fraud*, §2, at 226-227 (1992).

Moreover, provisions in the Acts that may appear to overlap, upon a closer look actually serve separate and distinct purposes. For example, the Third Circuit has suggested that

[13] *See*, Brief of *Amicus Curiae* Securities Association, Inc. in Support of Petitioners Alloyd Co., Inc. and Wind Point Partners II, L.P. at 13.

[14] The text of Section 17 is set forth in the Appendix to this brief.

[15] *United States v. Naftalin*, 441 U.S. 768, 777-78 (1979).

because Rule 10b-5 clearly applies to aftermarket trading and provides for a private right of action, but which also requires a more difficult standard for recovery than Section 12(2), Section 12(2) cannot be interpreted to apply to secondary market transactions or it would render Section 10(b) moot because purchasers would naturally bring suit under the lesser standard of Section 12(2).[16] A telling rebuttal to the Third Circuit's argument is:

> [T]he [Third Circuit] court nevertheless did not adequately address the fact that it may be possible to recover under Section 10(b) and not 12(2), since the former proscribes a wider range of conduct,[17] and the latter is subject to several procedural safeguards (footnote omitted); the possibility that to the extent of any overlap, a cumulation [sic] of remedies may not necessarily be inconsistent with the scheme of the legislation (footnote omitted); the fact that the Congress that adopted Section 12(2) could not have anticipated Rule 10b-5; or the implication of the Section 10(b) remedy and all of its elements being implied rather than express.[18]

Close attention should be given to the fact that Section 10(b), and Rule 10b-5, were not yet enacted or promulgated, let alone available to purchasers of securities, when Congress enacted Section 12(2).[19] It is a peculiar argument that because Rule 10b-5,

[16]*Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 692 (3d Cir. 1991).

[17]"Whereas Section 12(2) involves false and misleading statements in a prospectus or oral communication, Section 10(b) proscribes any 'manipulative or deceptive device or contrivance in contravention of SEC rules.'' H. Bloomenthal, *Securities Law Handbook*, § 14.05, at 14-36 (1933).

[18]*Id.*

[19]Section 10(b) was enacted by Congress as part of the Securities Exchange Act of 1934. 15 U.S.C. § 78j. Rule 10b-5 was adopted by the SEC in 1942. 17 CFR § 240.10b-5.

as it *now* exists, applies to aftermarket activity and requires a more difficult standard for recovery than Section 12(2), that Congress drafted Section 12(2) anticipating Rule 10b-5 and thus limited the application of Section 12(2) to initial distributions of securities so as to not render Rule 10b-5 superfluous.

Furthermore, when many of the legal articles regarding Section 12(2)were written and when many of the court cases were decided, an implied private right of action under Rule 10b-5 was firmly recognized. However, in light of *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 62 U.S.L.W. 4230 (Apr. 19, 1994) and the remarks of Justice Stevens in the dissent,[20] any implied private right of action is now suspect. Therefore, the application of the express private right of action under Section 12(2) becomes even more important as an investor protection mechanism.

Finally, "[T]he legislative history is too inconclusive to warrant disregarding the plain meaning of the language of Section 12(2). The consequence of doing so would have left defrauded investors no remedy in connection with secondary market transactions except for the fortuitous circumstance that Congress adopted Section 10(b) of the Exchange Act, the Commission adopted Rule 10b-5, and courts ultimately implied a private remedy for violations of Rule 10b-5."[21]

[20]Justice Stevens notes that 'the creation of new rights ought to be left to legislatures, not courts.' Musick, Peeler, 508 U.S., at ____ (slip op. at 5); and ". . . we are now properly reluctant to recognize private rights of action without an instruction from Congress. . ." *See Central Bank, at 11.*

[21]*Id.*

IV. PARALLEL FEDERAL AND STATE SECURITIES LAW PROVISIONS SHOULD BE INTERPRETED UNIFORMLY TO ENHANCE THE JOINT FEDERAL AND STATE REGULATORY AUTHORITY OVER THE SECURITIES MARKETS AND TO PROMOTE JUDICIAL ECONOMY.

Both the 1933 Act and the 1934 Act specifically preserve the rights of the states to regulate securities transactions within their own jurisdictions.[22] 15 U.S.C. §§ 77r and 78bb(a). Over 76 years ago, however, the state securities regulators recognized the need to cooperate and coordinate with each other in their regulation of the securities markets due to the national nature of the markets and in an effort to promote efficiency in states' securities regulation and enforcement activities. The state regulators facilitated this coordination through their membership in the North American Securities Administrators Association, Inc.,[23] formerly called the National Association of Securities Administrators. The

[22]Section 18 of the 1933 Act reads: Nothing in this title shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security of any person.

Section 28(a) of the 1934 Act, in pertinent part, reads: Nothing in this title shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person in so far as it does not conflict with the provisions of this title or the rules and regulations thereunder.

[23]In the United States, the North American Securities Administrators Association, Inc. ("NASAA') has as its members the securities regulators from all fifty states, the District of Columbia and Puerto Rico. Members are represented on various committees of the Association that are charged with developing proposed Statements of Policy to be presented to the membership as model or uniform securities regulations and are later considered by the individual jurisdictions for their implementation. The Association meets twice a year to vote on model Statements of Policy and resolutions presented for adoption.

Uniform Securities Act of 1956, and its adoption or substantial adoption by 41 states and jurisdictions of the United States, is a testament to the progress that has been made to coordinate state securities regulation.[24]

In addition to the coordination effort among the states, it has also been recognized that the state securities regulators and the federal securities regulator, the United States Securities and Exchange Commission (the "SEC"), should cooperate and attempt to coordinate their regulation of the United States securities markets.[25] Section 415 of the Uniform Act reads "This act shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it and to coordinate the interpretation and administration of this act with the related federal regulation (emphasis added).[26] In addition, Section 420 of the Uniform Act states, in part, that "To encourage uniform interpretation and administration of this act and effective securities regulation and enforcement, the [Administrator] may cooperate with the securities agencies or administrators of one or more states, [and] the Securities and Exchange Commission ..."[27]

Moreover, as was noted in the 1993 SEC Release for the Annual Conference on Uniformity of Securities Laws held prusuant to §19(c) of the 1933 Act:

[24]*See*, Jurisdictions Adopting the Uniform Securities Act, 1 Blue Sky L. Rep. (CCH) ¶5500 (1992).

[25]*See*, § 415 of the Uniform Securities Act (1956), *reprinted in* NASAA REPORTS (CCH) ¶4895 (1987); § 420 of the Uniform Securities Act (1956), *reprinted in* NASAA REPORTS (CCH) ¶4900 (1987) and § 19(c) of the Securities Act of 1933, 15 U.S.C. §77s, Pub. L. 96-477, 94 Stat. 2275 (October 21, 1980).

[26]Uniform Securities Act (1956), *reprinted in* NASAA REPORTS (CCH) ¶ 4895 (1987)

[27]Uniform Securities Act (1956), *reprinted in* NASAA REPORTS (CCH) ¶ 4900 (1987.

> The importance of facilitating greater uniformity in securities regulation was endorsed by Congress with the enactment of section 19(c) of the Securities Act in the Small Business Investment Incentive Act of 1980. Section 19(c) authorizes the Commission to cooperate with any association of state securities regulators which can assist in carrying out the declared policy and purpose of section 19(c). The policy of that section is that there should be greater federal and state cooperation in securities matters, including: (1) maximum effectiveness of regulation; (2) maximum uniformity in federal and state standards; (3) minimum interference with the business of capital formation; and (4) a substantial reduction in costs and paperwork to diminish the burdens of raising investment capital, particularly by small business, and a reduction in the costs of the administration of the government programs involved.[28]

In light of this prelude of authority recognizing the need for state and federal coordination regarding the regulation of securities, it becomes apparent that parallel federal and state securities laws should be interpreted uniformly. The language of states' statutes that mimic Section 410(a)(2) of the Uniform Act,[29] which is very similar to Section 12(2) of the 1933 Act, have been consistently interpreted to grant a private cause of action against sellers who make offers or sales of securities in the secondary market by means of any untrue statement of a material fact or a material omission.[30] However, as this Court

[28]Annual Conference on Uniformity of Securities Law, Securities Act Release No. 33-6985 (March 31, 1993) (available from the SEC).

[29]The text of Section 410(a)(2) is set forth in the Appendix to this brief.

[30]*Jenkins v. Jacobs*, [1987-88 Decisions] Blue Sky L. Rep. (CCH) ¶72,644; *Elbel v. Royale Energy Company*, [1991-93 Decisions] Blue Sky L. Rep. (CCH) ¶73,540; *Weft, Inc. v. G.C. Investments Associates*, [1986-87 Decisions] Blue Sky L. Rep. (CCH) ¶72,422.

recognizes, the federal courts, interpreting the language of Section 12(2), are split on this issue; some have extended liability only to initial public offerings and others have held that the liability extends to secondary market transactions.[31]

In an effort to further examine the intent behind the language of these sections, consideration should be given to the official comment to Section 410(a)(2), which, in part, states that "[T]his clause is almost identical to § 12(2) of the Securities Act of 1933," L. Loss, *Commentary on the Uniform Securities Act* at 146 (1958). In addition, the Draftsmen's Commentary to Section 410(a)(2) of the Uniform Act states that "The resemblance [of § 410(a)(2) of the Uniform Act] to § 12(2) of the Securities Act of 1933, 15 U.S.C. § 77l(2), will once more make for an interchangeability of federal and state judicial precedence in this very important area." *Id.* at 148.

The draftsmen, however, did recommend that if changes are to be made to Section 410(a)(2), "for clarity's sake", a language change replacing the words "by means of," which may be wrongly interpreted to require reliance by the purchaser, with the phrase "by use of any written or oral communication which contains any untrue statement...," should be considered. *Id.* The similarity of this proposed language to the language of Section 12(2), in light of the official comment to Section 410(a)(2), suggests that the draftsmen of the Uniform Act interpreted the term "prospectus," included in Section 12(2), to refer to any written communication. The draftsmen, however, did not recommend that a language change to Section 410(a)(2) should reference the term "prospectus," because the Uniform Securities Act does not define "prospectus" as is done in the 1933 Act.

[31]See the string citations in *T. Rowe Price New Horizons Fund, Inc. v. Preleta*, 749 F.Supp. 705, 707-08 (D. Md. 1990) (citing many cases both ways).

This point is well made by Bloomenthal in the *Securities Law Handbook* where he suggests that plaintiffs bring their 12(2) claims in state courts as pendent actions and include a claim under the state securities law counterpart.[32] He argues that "the state court may or may not follow *Ballay* on the Section 12(2) issue," but he strongly professes that the state claim will not fall victim to the word games of *Ballay*, although most state statutes follow the Uniform Act, which in this scenario, was modeled after Section 12(2). *Id.* at 14-38 — 14-39.

In light of the argument just made, the Court should also give some consideration to the vast backlog of cases that exist in the court systems today, and should discourage forum shopping and promote judicial economy at both the state and federal court levels, by interpreting Section 12(2) consistent with state court interpretations of the states' securities provisions that are the equivalent to Section 410(a)(2) of the Uniform Act. This would permit state and federal courts to share the burden of resolving cases on this matter and provide consistent outcomes for all investors making claims under these provisions.

A quick perusal of any securities law reporter will evidence that a substantial number of state securities law causes of action are brought as pendent actions in federal court. Thus, an interpretation of Section 12(2) that is different from Section 410(a)(2) of the Uniform Act would be a waste of judicial resources and create unfairness to investors who, most likely, would be forced to bring separate actions in both state courts and federal courts.

[32]H. Bloomenthal, *Securities Law Handbook*, § 14.05 at 14-38 (1993).

V. FAIRNESS AND OTHER CONSIDERATIONS OF GOOD PUBLIC POLICY REQUIRE THAT THE PRIVATE CAUSE OF ACTION CREATED BY SECTION 12(2) EXTEND TO SECONDARY MARKET TRANSACTIONS, WHETHER PUBLIC OR PRIVATE.

It is proper, and important, for this Court to consider public policy considerations when construing terms and provisions included in the 1933 Act.[33] A major policy consideration presented by the issue before the Court today is the question of fairness to investors. The Court must decide if it is good public policy to preclude those investors who purchase securities from someone other than an issuer (emphasis added) by means of a written document or an oral statement that includes an untrue statement of a material fact, or omits to state a material fact, from exercising a private right of action against the seller under Section 12(2).

The court in Wilko highlighted the absurdity of arbitrarily limiting Section 12(2) to initial distributions of securities only:

> Such a construction would frustrate the remedial purposes of the statute and lead to absurd and wholly incongruous results. The rights of a purchaser of securities publicly offered for sale would depend not upon whether fraud in fact was practiced, but upon the status of the vendor. Fraudulent sellers would be placed in two categories: one encompassing those engaged in the distribution of securities; the other, those engaged in trading transactions. Purchasers from sellers of the first category would have the protection and the benefit of the Act while purchasers from sellers of the latter category would not. Nothing

[33]*See, Pinter v. Dahl*, 486 U.S. 622, 653 (1988) (quoting *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 694 n. 7 (1985)).

in the Act reflects a more tender regard for the dishonest trader, nor a purpose to protect only purchasers defrauded by sellers other than traders.[34]

Moreover, by limiting Section 12(2) to initial distributions of securities, the Court would also send an unfortunate message to underwriters of securities offerings, that they are not responsible under Section 12(2) for contributing to the accuracy of the prospectus for use by all investors, which is in direct contradiction to the application of Section 12(1) to brokers and others that solicit purchases of securities as "statutory sellers."[35]

In addition, an argument has been made that applying Section 12(2) to secondary market transactions would have a draconian effect on the current operations of securities firms and securities analysts.[36] This argument is flawed for several reasons. First, although all the federal courts that have addressed this issue have not applied Section 12(2) to secondary market transactions, some have. Assuming the securities industry is aware of these decisions extending civil liability under Section 12(2), there does not appear to be any obvious "chilling effect" currently occurring regarding the operations of the securities firms. Second, despite the split of opinions in the federal courts, the states' courts have applied civil liability under their statutes that mirror Section 410(a)(2) of the Uniform Act to aftermarket trading[37] and, once again, no "chilling effect" appears to have occurred. Finally, securities firms and their agents currently have the same obligation to review and monitor their communications with the public under the National Association of Securities Dealers, Inc. ("NASD") Rules of Fair Practice.[38] Moreover, most states follow NASAA's Statement of Policy on Dishonest or Unethical Business Practices[39] which requires brokerdealers and agents to monitor their distribution of materials used in the conduct of their business.

[34] *Wilko v. Swan*, 127 F. Supp. 55, 59 (S.D.N.Y. 1955).

[35] *Pinter v. Dahl*, 486 U.S. 622, 646 (1988).

[36] *See*, Brief of Amicus Curiae Securities Industry Association, Inc. in Support of Petitioners Alloyd Co., Inc. and Wind Point Partners II, L.P.

[37] *See*, Note 28.

It is perfectly appropriate to require securities professionals to operate fairly in the marketplace with investors who don't have the same level of sophistication, nor the same access to information as those who are licensed and employed to do so. Subjecting securities professionals, as well as all sellers, to the negligence[40] standard of liability under Section 12(2) merely requires sellers to exercise reasonable care, ***under the circumstances***, regarding their communications in the sale of their securities. It stands to reason that securities professionals, insiders and average investors all have access to different types of information. Requiring all sellers to disclose material information or to verify the information included in communications they use in the sale of their securities, based on the information reasonably available to the "seller," is good public policy.

[38] Article III, Section 35, *Communications With the Public*, National Association of Securities Dealers, Inc. Manual — Rules of Fair Practice ¶2195 (1995).

[39] *Dishonest or Unethical Business Practices*, NASAA REPORTS (CCH) ¶1401 (1983); Finding Lists, NASAA REPORTS (CCH) ¶ 6211.

[40] "Negligence is the failure to use such care as a resasonably prudent and careful person would use under similar circumstances; it is the doing of some act which a person of ordinary prudence would not have done under similar circumstances." BLACK'S LAW DICTIONARY at 930-31 (5th ed. 1979) (quoting *Amoco Chemical Corp. v. Hill*, 318 A.2d 614, 617 (Del. Super. 1974)).

CONCLUSION

The Seventh Circuit, along with the First and the Tenth Circuits have it right; Section 12(2) of the 1933 Act is applicable to secondary market transactions. Any other interpretation would suggest that Congress was not concerned about the protection of all investors when it enacted the 1933 Act, but only reacted to the market crash of 1929 by protecting investors in the principal market from erroneous and inadequate disclosures, with no regard to the lack of investor confidence that could result in the aftermarket. We do not believe that Congress was so short-sighted when it enacted the 1933 Act.

Respectfully Submitted

KAREN M. O'BRIEN
General Counsel
North American Securities
Administrators Association, Inc.
One Massachusetts Avenue, N.W.
Washington, D.C. 20001
(202) 737-0900

APPENDIX

Section 12(2) of the 1933 Act, 15 U.S.C. §77l:

Any person who

* * *

> (2) offers or sells a security (whether or not exempted by the provisions of section 77c [section 3] of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, upon the tender of such security, or for damages if he no longer owns the security.

Section 2(10) of the Securities Act of 1933, 15 U.S.C. § 77b(10):

The term "prospectus" means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security; except that (a) a communication sent or given after the effective date of the registration statement (other than a prospectus permitted under subsection (b) of section 10) shall not be deemed a prospectus if it is proved that prior to or at the same time with such communication a written prospectus meeting the requirements of subsection (a) of section 10 at the time of such communication was sent or given to the person whom the communication was made, and (b) a notice, circular, advertisement, letter, or communication in respect of a security shall not be deemed to be a prospectus if it states from whom a written prospectus meeting the requirements of section 10 may be obtained and, in addition, does no more than identify the security, state the price thereof, state by whom orders will be executed, and contain such other information as the Commission, by rules or regulations deemed necessary or appropriate in the public interest and for the protection of investors, and subject to such terms and conditions as may be prescribed therein, may permit.

Section 17 of the 1933 Act, 15 U.S.C. § 77q:

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly -

(1) to employ any device, scheme or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

(b) It shall be unlawful for any person, by the use of means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicly to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

(c) The exemptions provided in section 77c of this title shall not apply to the provisions of this section.

Section 410(a)(2) of the Uniform Securities Act, NASAA REPORTS (CCH) ¶ 4927:

Any person who

(2) offers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading (the buyer not knowing of the untruth or omission), an who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or the omission

is liable to the person buying the security from him, who may sue either at law or in equity to recover the consideration paid for the security, ***.

(8)

No. 93-404

In The

Supreme Court of the United States

October Term, 1993

ARTHUR L. GUSTAFSON, DANIEL R. McLEAN and FRANCIS I. BUTLER,

Petitioners,

vs.

ALLOYD CO., INC. and WIND POINT PARTNERS II, L.P.,

Respondents.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Seventh Circuit

BRIEF OF AMICUS CURIAE NATIONAL ASSOCIATION OF SECURITIES AND COMMERCIAL LAW ATTORNEYS ("NASCAT") IN SUPPORT OF RESPONDENTS

JONATHAN W. CUNEO
General Counsel
NATIONAL ASSOCIATION OF SECURITIES AND COMMERCIAL LAW ATTORNEYS
317 Massachusetts Avenue, N.E.
Suite 300
Washington, D.C. 20002
Telephone: 202/789-3960

PATRICK E. CAFFERTY
(Counsel of Record)
MILLER FAUCHER CHERTOW CAFFERTY AND WEXLER
30 North LaSalle St.
Suite 3200
Chicago, IL 60602
Telephone: 312/782-4880

Attorneys for Amicus Curiae

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
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QUESTION PRESENTED

Whether Section 12(2) of the Securities Act of 1933 extends to a privately negotiated sale of stock.

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I. INTRODUCTION AND INTEREST OF AMICUS CURIAE

The National Association of Securities and Commercial Law Attorneys ("NASCAT") is an association of law firms and attorneys located throughout the United States. NASCAT and its members advocate the enactment and enforcement of effective laws to protect investors from deceptive and manipulative practices and to ensure that

the United States securities markets operate freely and efficiently. NASCAT's members frequently represent plaintiffs in a variety of individual, class action and derivative cases prosecuted under the federal securities laws. NASCAT and its members have an interest in the effective private enforcement of the federal securities laws and in developing case law that deters potential wrongdoers from perpetrating securities fraud violations upon investors in this country. This brief is filed with the written consent of the parties.

NASCAT and its members have an interest in this case because the Court's decision will affect the application of Section 12(2) of the Securities Act of 1933 (the "1933 Act"), 15 U.S.C. § 77*l*(2), to secondary market transactions in publicly traded securities. Although the issue before the Court is framed in terms of Section 12(2)'s application to a privately negotiated sale of stock, the conflicting circuit court opinions directly affect Section 12(2)'s application to secondary market transactions. NASCAT is strongly opposed to the contention of Petitioners and their amici[1] that Section 12(2) be restricted to initial public offerings. Such a construction would require a disregard of the plain text of Section 12(2) and decades of practice.[2]

[1] The Securities Industry Association, Inc. ("SIA") has filed an *amicus curiae* brief in support of Petitioners.

[2] In each of the following opinions, for example, the courts did not question the availability of section 12(2) to postdistribution trading: *Cady v. Murphy*, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940); *Woodward v. Wright*, 266 F.2d 108, 116 (10th Cir. 1959); *Franklin Sav. Bank v. Levy*, 551 F.2d 521 (2d Cir. 1977); *Yancoski v. E.F. Hutton & Co.*, 581 F. Supp. 88, 93 (E.D. Pa. 1983); *Carrott v. Shearson Hayden Stone, Inc.*, 724 F.2d 821 (9th Cir. 1984); *Roger v. Leaman Bros. Kuhn Loeb, Inc.*, 604 F. Supp. 222, 224 (S.D. Ohio 1984); *Monetary Management of St. Louis, Inc. v. Kidder Peabody & Co.*, 615 F. Supp. 1217, 1219-1223 (E.D. Mo. 1985); *Quincy Co-op Bank v. A.G.Edwards & Sons, Inc.*, 655 F. Supp. 78, 84 (D. Mass. 1986); *Short v. Belleville Shoe Mfg. Co.*, 908 F.2d 1385, 1390 (7th Cir. 1990) (dicta), *cert. denied*, ___ U.S. ___, 111 S. Ct. 2887, 115 L. Ed. 2d 1052 (1991).

The Third Circuit was the first circuit court to expressly consider the issue. In *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682 (3d Cir. 1991), *cert. denied*, ___ U.S. ___, 112 S. Ct. 79, 116 L. Ed. 2d 52 (1991), the court concluded that Section 12(2)'s application was limited to primary distributions. However, in *Pacific Dunlop Holdings, Inc. v. Allen & Co., Inc.*, 993 F.2d 578 (7th Cir. 1993), *cert. granted*, ___ U.S. ___, 114 S. Ct. 907, 127 L. Ed. 2d 98, *cert. dismissed*, ___ U.S. ___, 114 S. Ct. 1146, 127 L. Ed. 2d 454 (1994), the Seventh Circuit reached the opposite result, finding that the textual clarity and corresponding legislative history of Section 12(2) demonstrated its application to all sales of securities.[3] In the case before the Court, the Seventh Circuit vacated a grant of summary judgment in favor of defendants and remanded for reconsideration in light of *Pacific Dunlop*. After the writ of certiorari in *Pacific Dunlop* was dismissed, this Court granted the petition for a writ of certiorari here. *Gustafson v. Alloyd Co.*, ___ U.S. ___, 114 S. Ct. 1215, 127 L. Ed. 2d 562 (1994).

[3] In *First Union Discount Brokerage Serv. v. Milos*, 997 F.2d 835, 843-844 (11th Cir. 1993), the Eleventh Circuit followed *Ballay* without expanding on its reasoning.

NASCAT, as *amicus curiae*, respectfully submits that the Seventh Circuit's order in this case, following its thoughtful decision in *Pacific Dunlop*, should be affirmed and that this Court should specifically hold that the express right of action under Section 12(2) is not limited to initial public offerings.

II. SUMMARY OF ARGUMENT

The issue before the Court is whether Section 12(2) "extends to a privately negotiated sale of stock." Intertwined with this issue is whether or not Section 12(2) applies to any purchase of a security other than through an initial public offering. By its plain language, Section 12(2) also protects purchasers in private transactions and purchasers on secondary markets.[4] Since the overwhelming majority of transactions in securities are on secondary markets, it is difficult to imagine that the drafters of Section 12(2) would exclude these transactions from coverage without express language.[5] *See Wilko v. Swan*, 127 F.

[4] Section 12(2) is an important remedy for abusive sales practices utilized in secondary markets. *See, e.g., Farley v. Baird, Patrick & Co.* 750 F. Supp. 1209 (S.D.N.Y. 1990); *Hoxworth v. Blinder Robinson & Co.*, 1989 WL 56113, 1989 U.S. Dist LEXIS 5729 (E.D. Pa. May 23, 1989), *vacated on other grounds*, 903 F.2d 186 (3d Cir. 1990).

[5] *See* Louis Loss, Comment, *The Assault on Securities Act Section 12(2)*, 105 Harv. L. Rev., 908, 916 (1992) ("[I]t is almost inconceivable that these two great statutes [*i.e.*, the 1933 Act and the 1934 Act] – which repeatedly have been treated as *in pari materia* – were meant to afford no civil remedy whatsoever to the great bulk of investors who do not participate in distributions." [footnote omitted.]).

Supp. 55, 59 (S.D.N.Y. 1955) ("Nothing in the [1933] Act reflects a more tender regard for the dishonest trader, nor a purpose to protect only purchasers defrauded by sellers other than traders."). It is also inconceivable that Congress intended to exclude Section 12(2)'s application to private securities transactions, when it expressly exempted such transactions only from the registration requirements of the 1933 Act. *See* 15 U.S.C. § 77d(2).

This Court should hold that Section 12(2) applies, as the statute reads, to any person who "offers or sells a security", whether it is publicly traded or not. The plain language of the statute, including a broad definition of the terms "security" and "prospectus",[6] do not restrict Section 12(2)'s application to initial public offerings. *See infra* § III.A.

Related provisions of the 1933 Act support a broad reading of Section 12(2). Section 4(2), 15 U.S.C. § 77d(2), exempts private securities transactions from the Act's registration requirements, but not the antifraud provisions. *See infra* § III.B.1. Section 13, 15 U.S.C. § 77m, provides a three-year period of repose that commences with "the sale" (as opposed to the date "bona fide offered to the public" as used for Sections 11 and 12(1)[7]), thereby demonstrating application to transactions other than initial public offerings. *See infra* § III.B.2. In addition, the language of Section 12(2) is similar in scope to Section 17(a), 15 U.S.C. § 77q(a), which, as this Court has held,

[6] 15 U.S.C. § 77b(1), (10).

[7] 15 U.S.C. §§ 77k, 77l(1).

applies to postdistribution transactions. *United States v. Naftalin*, 441 U.S. 768, 778 (1979). *See infra* § III.B.3.

Interpreting Section 12(2) in light of the implied right of action under Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 77j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, does not support a restrictive interpretation of Section 12(2), as the *Ballay* Court erroneously held. A comparison of these causes of action is ahistorical and in no way demonstrative of a legislative intent to limit Section 12(2) to primary markets. *See infra* § III.C.

Finally, the available legislative history, if considered, demonstrates that Section 12(2) was intended to apply to all transactions in sêcurities. *See infra* § III.D.

III. ARGUMENT

A. SECTION 12(2), BY ITS PLAIN LANGUAGE, APPLIES TO ALL SALES OF SECURITIES.

To interpret Section 12(2), the Court must look first to the express language of the statute. If the language of the statute is clear, that is the end of the matter. *See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, ___ U.S. ___, 114 S. Ct. 1439, 1446, 128 L. Ed. 2d 119 (1994); *Good Samaritan Hospital v. Shalala*, ___ U.S. ___, 113 S. Ct. 2151, 2157, 124 L. Ed. 2d 368 (1993). The Court must enforce the unambiguous language in the absence of a clearly expressed legislative intent to the contrary. *Reves v. Ernst & Young*, ___ U.S. ___, 113 S. Ct. 1163, 1169, 122 L. Ed. 2d 525 (1993); *United States v. Turkette*, 452 U.S. 576,

580 (1981).[8] Section 12(2), the text of which is set out in the footnote below, provides for a cause of action with the following elements:[9]

1. Defendant offered or sold "a security";
2. By the use of any means of communication in interstate commerce;
3. Through a "prospectus" (defined to include notice, circular, advertisement, letter, or communication[10]) or oral communication;
4. By making a false or misleading statement of material fact necessary in order to make

[8] In *Randall v. Loftsgaarden*, 478 U.S. 647, 656 (1986) this Court found that the remedy analysis of Section 12(2) "speaks with the clarity necessary to invoke this 'plain meaning' canon." *See Pacific Dunlop*, 993 F.2d at 589.

[9] Section 12(2) (15 U.S.C. § 77*l*(2)), provides that "[a]ny person who – * * * offers or sells a security (whether or not exempted by the provisions of [Section 3], other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security."

[10] 15 U.S.C. § 77b(10).

> the statements, in light of the circumstances under which they were made, not misleading;[11]

5. Plaintiff did not know of the untruth or the omission; and
6. Defendant knew, or in the exercise of reasonable care, could have known of the untruth or omission.

See Monetary Management Group, Inc. v. Kidder, Peabody & Co., 615 F. Supp. 1217, 1222 (D.C. Mo. 1985); *Darrah-Wantz v. Brown*, 138 F.R.D. 20, 23-24 (D. Conn. 1991).[12]

The purpose and effect of Section 12(2) is unambiguous – *i.e.*, as between a purchaser and a seller, the seller will bear the consequences of a false statement or omission of material fact, be it oral or written, unless the seller can demonstrate that he or she was not at fault. *See Quincy Co-op Bank v. A.G. Edwards & Sons, Inc.*, 655 F. Supp. 78, 84 (D. Mass. 1986). The rescissory damage remedy could include recovery of losses unrelated to the misstatement or omission, such as market losses incurred after the transaction. *See Randall v. Loftsgaarden*, 478 U.S. 647, 659 (1986) ("Congress shifted the risk of an intervening decline in the value of the security to defendants,

[11] A material fact exits, under the federal securities laws, when there is a substantial likelihood that a reasonable investor would consider the fact important enough to alter the "total mix" of information available. *See Basic, Inc. v. Levinson*, 485 U.S. 224, 231-232 (1988); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

[12] *See also* Theresa H. Maynard, *Liability under Section 12(2) of the Securities Act of 1933 for Fraudulent Trading in Postdistribution Markets*, 32 Wm. & Mary L. Rev. 847, 851 (1991).

whether or not that decline was actually caused by the fraud."); *Hoxworth v. Blinder Robinson & Co.*, 903 F.2d 186, 203 n.25 (3d Cir. 1990).[13]

As Section 12(2) applies to any person who offers or sells "a security," the question concerning the scope of its application is readily answered by the definition of the term "security". Section 2(1) of the 1933 Act, 15 U.S.C. § 77b(1), defines "security" broadly, including "any note, stock, treasury stock, bond" among numerous others. Whether or not an investment even meets the requirements of a "security" under the 1933 Act may be a question of fact. *See Sec. & Exch. Comm'n. v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946) (The definition of "security" in the 1933 Act embodies "a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."); *see also Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985). It is beyond dispute that closely held stock and stock traded on secondary markets fit easily within the definition of "security." Congress would not have defined "security" broadly had it intended the term, as applied in Section 12(2) without qualification, to cover only stocks in initial public offerings.[14]

[13] Section 12(2) is a legislative modification of common law deceit with an element of equitable rescission. *See* Loss, Comment, *The Assault on Securities Act Section 12(2)*, 105 Harv. L. Rev., 908, 910 (1992); IX Loss & Seligman, *Securities Regulation* 4199-4207 (3d ed. 1992).

[14] It is the offer or sale of a "security" defined by Section 2(1) that triggers the application of Section 12(2). Thus, the question should be "Is it a security?" not "What kind of security

1. The Broad Definition of "Prospectus" in the 1933 Act is Unambiguous.

The linchpin of *Ballay*'s reasoning is that the term "prospectus" in Section 12(2) evinces Congress' intention to limit its application to the initial public offering. The court in *Ballay* indicated that if it "had intended an expansive meaning for the term 'prospectus', Congress more simply could have drafted section 12(2) to describe all 'written and oral communications'." 925 F.2d 689. Contrary to the *Ballay* Court's argument, Congress did just that. The definition of "prospectus" in Section 2(10) "essentially states that any written offer constitutes a prospectus". IX Louis Loss & Joel Seligman, *Securities Regulation* 4220 (3d ed. 1992). Section 2(10) defines "prospectus" as including any "notice, circular, advertisement, letter, or communication."

Instead of the definition set out in Section 2(10), *Ballay* adopted a much more restricted definition of "prospectus" from Section 10 of the 1933 Act, 15 U.S.C. § 77j, which specifies the contents of a "prospectus." The *Ballay* Court concluded that a "prospectus" for purposes of Section 12(2) must mean a document which meets the requirements of Section 10. 925 F.2d at 688-689. However,

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is it?" Here, the application of Section 12(2) can be established by the following syllogism: Section 12(2) applies to the offer and sale of "a security." The stock of Alloyd Company constitutes "a security." 15 U.S.C. § 77b(1) ("stock"). Therefore, Section 12(2) applies to the offer and sale of stock of Alloyd Company. As Professor Loss has stated, "all one needs to do here is to *read the words* in the relevant provisions." Loss, Comment, *The Assault on Securities Act Section 12(2)*, 105 Harv. L. Rev., 908, 917 (1992) (footnoted omitted; emphasis in original).

a "prospectus" that meets the requirements of Section 10 is merely a sub-group of the larger group of written communications falling under Section 2(10)'s definition of "prospectus" and not a substitute for the general definition provided by Congress. *PPM America, Inc. v. Marriott Corp.*, 820 F. Supp. 970, 977 (D. Md. 1993).

Section 10 requires that a "prospectus" contain, for the most part, the information set forth in the registration statement required by Section 5 of the 1933 Act. 15 U.S.C. § 77e. The requirements of Section 10 are enforced through Section 5, which provides that it is unlawful to "carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under [the 1933 Act], unless such prospectus meets the requirements of section 10". 15 U.S.C. § 77e(b)(1). A "prospectus" must therefore meet the requirements of Section 10 "only if the prospectus relates to a security for which a registration statement has been filed." *PPM America, Inc. v. Marriott Corp.*, 820 F. Supp. 970, 977 (D. Md. 1993). A registration statement need not be filed every time a security is offered or sold. *See* Sections 3 and 4 of the 1933 Act, 15 U.S.C. §§ 77c and 77d (exempting a significant number of securities and transactions from Section 5 registration). Thus, a Section 10 prospectus is required for some, but not all, "securities" as defined by the 1933 Act. *See* 15 U.S.C. § 77b(1).

In sharp contrast to Section 10, Section 12(2) applies to *all* securities transactions, including those subject to Section 3 and Section 4 exemptions. *See Woodward v. Wright*, 266 F.2d 108, 116 (10th Cir. 1959) (Section 12(2) applies to securities "whether exempt from registration

or not".); II Loss & Seligman, *Securities Regulation* 906-907 (3d ed. 1992) ("[T]he exemptions generally do not apply to the antifraud provisions of §§ 12(2) and 17."). In *Sec. Indus. Assoc. v. Bd. of Governors of the Fed. Reserve Sys.*, 468 U.S. 137, 151 (1984), for example, this Court noted that rather than amend the definition of "security" in the 1933 Act to exclude commercial paper, "Congress chose instead to exempt commercial paper only from the registration requirements of the statute, see 15 U.S.C. § 77c(a)(3), while preserving application of the statute's antifraud provisions to all commercial-paper 'securities.' §§ 77*l*, 77q(c)." (footnote omitted.) *See* 15 U.S.C. § 77b(1). Therefore, *Ballay* erroneously limited Section 12(2) coverage to only those situations where Section 10 applies.

This Court has noted that "[w]hen a word is not defined by statute, we normally construe it in accord with its ordinary or natural meaning." *Smith v. United States*, ___ U.S. ___, 113 S. Ct. 2050, 2054, 124 L. Ed. 2d 138 (1993). When a word *is* defined by the statute, of course, it must be construed according to the definition. The definition of "prospectus" in Section 2(10), not the more limited use of the term in Section 10, applies to Section 12(2). Congress' definition simply cannot be ignored. *See Pacific Dunlop* 993 F.2d at 586 (*Ballay*'s "approach would result in an entirely new definition in place of section 2(10).").

2. The Available Measure of Damages Under Section 12(2) is not Inconsistent with Secondary Market Trading.

The *Ballay* Court also found that the remedies available under Section 12(2) (*i.e.* rescission or rescissory damages) logically applied to initial distributions but not to the secondary market, thereby evincing Congress' intent to limit Section 12(2) to distributions.

> These sellers [*i.e.* distribution] receive the full purchase price from the investors and are the investors' sole source of information concerning the value of the security. The same is not true in the aftermarket, such as Legg Mason, who receive only a commission and who are not the investors' sole source of information concerning the value of the stock.

925 F.2d at 693.

Ballay's reasoning is inapposite because Congress did not provide for a rescission in Section 12 because of the logic of applying it to sellers. "Congress chose rescission for its *effects*". *Pinter v. Dahl*, 486 U.S. 622, 647-48 n.23 (1988) (emphasis added). This measure of damages was selected "in part because of the additional measure of deterrence provided by rescission as compared to a purely compensatory measure of damages." *Id.*; *see also Randall v. Loftsgaarden*, 478 U.S. 647, 659 (1986). In addition, in keeping with the powerful deterrent effect of rescission or rescissory damages, "the risk of its invocation should be felt by *solicitors* of purchasers." *Pinter*, 486 U.S. at 646 (emphasis added); *see also Commercial Union Assurance Co., PLC v. Milken*, 17 F.3d 608, 616 (2d Cir. 1994). Thus, a "seller" under Section 12(2) is defined far more broadly than the person who actually transfers title and receives payment. *See infra* § III.C. If a rescissory remedy is available against these "sellers" at the initial offering, nothing is amiss with such a remedy in the

secondary market.[15] Indeed, a seller in the secondary market (as opposed to the issuer in a public offering) could well receive the full purchase price from the investor.[16]

In sum, Section 12(2), by its plain language, applies to all transactions in securities.

B. CONSIDERATION OF SECTION 12(2) IN CONJUNCTION WITH OTHER PROVISIONS OF THE 1933 ACT SUPPORTS A BROAD INTERPRETATION OF THE STATUTE.

Section 12(2)'s application to all securities transactions is supported by a consideration of similar and related provisions in the 1933 Act, specifically Sections 4(2), 13 and 17(a). 15 U.S.C. §§ 77d(2), 77m, 77q(a).

1. Section 12(2) Applies to Private Securities Transactions.

The 1933 Act includes a "private offer" exemption in Section 4(2), 15 U.S.C. § 77d(2). It provides that the registration requirements of Section 5, 15 U.S.C. § 77e, "shall

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[15] In *Ballay*, had Legg Mason received only a commission on an initial offering, its liability under Section 12(2) would be beyond dispute. In fact, the broker's commission itself is an element of the damages. *See Stadia Oil & Uranium Co. v. Wheelis*, 251 F.2d 269, 276 (10th Cir. 1957) (plaintiff is entitled to restoration of entire purchase price).

[16] "[T]here can be a 'security' without an 'issuer,' the definition of the latter term being important only because the 'issuer' must sign a registration statement under § 6 [15 U.S.C. § 77f] and is absolutely liable for material defects in it under § 11. By contrast, §§ 12 and 17(a) refer to any 'person' who sells." II Loss & Seligman, *Securities Regulation* 908 (3d ed. 1992).

not apply to . . . transactions by an issuer not involving any public offering." The private offer exemption relates only to the registration requirements of Section 5 and does not exempt a transaction from the antifraud provision of Section 12(2). *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 692 (1985) ("[A]lthough § 4(2) of the 1933 Act exempts transactions not involving any public offering from the Act's registration provisions, there is no comparable exemption from the antifraud provisions."); *Pacific Dunlop*, 993 F.2d at 587. *See also Nor-Tex Agencies, Inc. v. Jones*, 482 F.2d 1093, 1099 (5th Cir. 1973), *cert. denied*, 415 U.S. 977 (1974); *Haralson v. E.F. Hutton Group, Inc.*, 919 F.2d 1014, 1032 (5th Cir. 1990). The fact that Congress chose to exempt private securities transactions from registration, but not from the antifraud provisions, demonstrates a deliberate congressional choice with which the courts should not interfere. *Cf. Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. at 1452 ("The fact that Congress chose to impose some forms of secondary liability, but not others, indicates a deliberate congressional choice with which the courts should not interfere.").

2. The Statute of Limitations for Section 12(2) Commences with "the Sale" as Opposed to the Date "Bona Fide Offered to the Public."

The statute of limitations and period of repose for the private rights of action under Sections 11, 12(1) and 12(2), 15 U.S.C. §§ 77k, 77*l*, are set forth in Section 13 of the 1933 Act. 15 U.S.C. § 77m. Section 13 makes an unmistakable distinction between the causes of action in Sections 11 and 12(1), on the one hand, and Section 12(2) on the

other. Section 11 and 12(1) both involve liability related to registration statements required by Section 5 – Section 11 for a false registration statement and Section 12(1) for not submitting a required registration statement. The period of repose for Sections 11 and 12(1) commences when the stock is "bona fide offered to the public", which recognizes that truly private securities transactions cannot result in liability because of the exemption from registration in Section 4(2). *See also Pacific Dunlop*, 993 F.2d at 585-586 n.12. Section 12(2), however, applies to "[a]ny person who . . . offers or sells a security" and the period of repose necessarily commences with "the sale". 15 U.S.C. § 77m. There is no mention of an offer to the public, because (unlike Sections 11 and 12(1)) an offer to the public is not required to violate Section 12(2), only an offer or sale of "a security" based on material misstatements or omissions.[17]

Had Congress intended to restrict Section 12(2) to initial public offerings, its period of repose would logically have also commenced with the bona fide offering to the public. By commencing the period with the sale, however, Congress expressly envisioned a far wider application. This Court should therefore reject Petitioners' invitation upset Congress' carefully balanced language in Sections 4, 5, 11, 12(1), 12(2) and 13 by restricting Section 12(2)'s application to initial public offerings.

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[17] *See* II Loss & Seligman, *Securities Regulation* 908 (3d ed. 1992), quoted in the previous footnote.

Ballay found that the placement of Section 12(2) – *i.e.* after Sections 11 and 12(1) and before Section 13 – was demonstrative of an intent to limit its application to initial offerings because "[a]ll of these sections deal with initial distributions." 925 F.2d at 691. This "structure" contention was properly rejected by the Seventh Circuit in *Pacific Dunlop*, 993 F.2d at 585-586; *see also PPM America, Inc.*, 820 F. Supp. at 978 ("That reasoning is based on little more than the location of § 12(2) in the 1933 Act and ignores other provisions of the Act which reveal its true structure."). It is also wrong in its premise because, as it relates to Section 12(2), Section 13 does not "deal with initial distributions." 925 F.2d at 691. Thus, the *Ballay* Court's attempt to glean legislative intent from the "structure" of the 1933 Act simply does not support a restrictive reading of Section 12(2).

3. The Application of Section 17(a) of the 1933 Act to the Secondary Markets Supports a Similar Application of Section 12(2).

It is also worth considering Section 17(a) of the 1933 Act, which criminalizes certain fraudulent practices by "any person in the offer or sale of securities." 15 U.S.C. § 77q(a). Section 12(2) is, in many respects, the civil liability analogue to Section 17(a). IX Loss & Seligman, *Securities Regulation* 4219 (3d ed. 1992). Neither Section 17(a) nor Section 12(2) makes a distinction between initial distributions and secondary market trading. *See Barnes v. Osofsky*, 373 F.2d 269, 272 (2d Cir. 1967) ("In contrast [to § 11] both §§ 12(2) and 17, the antifraud sections of the 1933 Act, . . . are not limited to the newly registered securities."). This Court held that "[u]nlike much of the

rest of the [1933] Act, [Section 17(a)] was intended to cover any fraudulent scheme in the offer or sale of securities, whether in the course of an initial distribution or in the course of ordinary market trading." *United States v. Naftalin*, 441 U.S. 768, 778 (1979). The Court's construction of Section 17(a) plainly extends to Section 12(2). *See* Loss, Comment, *The Assault on Securities Act Section 12(2)*, 105 Harv. L. Rev., 908, 915-916 (1992).

In an effort to distinguish *Naftalin*, the court in *Ballay* found that Section 12(2) was drawn more narrowly than Section 17(a).

> The plain words, "directly or indirectly" and "*any* device" of section 17(a) differ from the specific "prospectus or oral communication" language of section 12(2). Had Congress intended section 12(2) to extend to liability for secondary transactions, it could have preceded "oral communications" with "any" and explicitly stated its special intent in legislative history.

925 F.2d at 692 (emphasis added by court). The *Ballay* Court's analysis ignores the plain wording of Section 12(2), which is substantially similar to Section 17(a) in terms of its scope. Section 17(a) applies to "any person in the offer or sale of any securities", 15 U.S.C. § 77q(a), while Section 12(2) applies to "[a]ny person who . . . offers or sells a security", 15 U.S.C. § 77*l*(2). Section 12(2)'s reference to "a security" in the singular, and Section 17(a)'s reference to "any securities" in the plural, is a mere difference in draftsmanship that does not carry substantive implications. *See* 15 U.S.C. § 77b(1).

While the 1933 Act was, no doubt, primarily concerned with the regulation of new offerings, Section 17(a)

was not the only departure from that purpose; Section 12(2) is another departure. *Naftalin* holds that, absent specific language to the contrary, the 1933 Act is not restricted to initial offerings. *See Pacific Dunlop*, 993 F.2d at 593 ("[N]othing in the Supreme Court's reasoning in *Naftalin* directs that a broad reading of section 17 dictates a narrow reading on the remainder of the 1933 Act."). The Court's reasoning in *Naftalin*, therefore, strongly supports Section 12(2)'s application to secondary markets.

C. THE OVERLAP BETWEEN SECTION 12(2) AND SECTION 10(b) OF THE 1934 ACT IS "NEITHER UNUSUAL NOR UNFORTUNATE."

On some facts, Section 12(2) and Section 10(b) provide concurrent causes of action.[18] As both *Ballay* and *Pacific Dunlop* properly noted, the 1933 and 1934 Acts should be construed as *in pari materia*, that is, as coordinating statutes which contain some overlapping provisions. This Court has reaffirmed that " 'the fact that there may well be some overlap [between the two Acts] is neither unusual nor unfortunate.' " *Herman & MacLean v. Huddleston*, 459 U.S. 375, 383 (1983), quoting *United States v. Naftalin*, 441 U.S. 768, 778 (1979).

Nevertheless, *Ballay* found that a postdistribution cause of action under Section 12(2) would render purchaser actions under Section 10(b) "superfluous." 925 F.2d at 692-693 & n. 13. The court reasoned that plaintiffs would never have reason to sue under Section 10(b), since

[18] *See, e.g., Carrott v. Shearson Hayden Stone, Inc.*, 724 F.2d 821 (9th Cir. 1984).

they could receive a better remedy while enjoying a much more relaxed burden of proof under Section 12(2). 925 F.2d at 692-93. Section 12(2), unlike Section 10(b), requires no proof of scienter, or reliance, and embodies a more relaxed standard of causation. "If it were determined that section 12(2) applied to secondary market trading, the more lenient requirements of section 12(2) would effectively eliminate the use of section 10(b) by securities purchasers. Such a construction would overrule, *sub silentio*, section 10(b) as a remedy for purchasers." 925 F.2d at 692-693 (footnote omitted).[19]

As a matter of both practice and statutory construction, the *Ballay* Court's analysis is specious. Congress adopted Section 10(b) of the 1934 Act "as a nonself-executing, catchall fraud prophylactic" in case the more specific antifraud provisions "proved to be no match for the ingenuity of the securities community." IX Loss &

[19] Section 12(2) does not necessarily provide a better remedy, assuming a choice of remedies is available. In *Randall*, this Court reserved the issue of whether a rescissory measure of damages may be appropriate for defrauded buyers under Rule 10b-5. 478 U.S. at 661-662. While some courts have rejected this remedy under Rule 10b-5, *see Sharp v. Coopers & Lybrand*, 649 F.2d 175, 190 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982), others have approved rescissory remedies on certain facts. *See Bruschi v. Brown*, 876 F.2d 1526, 1532 (11th Cir. 1989); *Gordon v. Burr*, 506 F.2d 1080, 1085 (2d Cir. 1974). In addition, one who purchased a security that has *increased* in value certainly would not want a rescissory remedy, rendering Section 12(2) – but not Section 10(b) – inapplicable. *Cf. Rand v. Monsanto Co.*, 926 F.2d 596, 600 (7th Cir. 1991) (that investor eventually made a profit on a stock "does not disqualify him from recovering any loss attributable to the concealment of material information that Monsanto had a duty to disclose.").

Seligman, *Securities Regulation* 4219-4220 (3d ed. 1992). A "catchall" need not be an exclusive remedy; overlap on certain facts with other causes of action is inevitable.[20]

To begin with, interpreting Congress' intent when adopting Section 12(2) in light of the cause of action that has evolved under Rule 10b-5 is unfounded because Rule 10b-5 simply did not exist at the time of Section 12(2)'s enactment. "[A] comparison of these two sections is ahistorical and is not useful in interpreting the meaning of 12(2)." *PPM America, Inc. v. Marriott Corp.*, 820 F. Supp. 970, 976 (D. Md. 1993). As Professor Loss has stated:

> No one could have anticipated in 1934 that rule 10b-5 would be adopted eight years later, let alone that the courts would imply a private right of action for its violation (hence rendering it the primary vehicle for private litigation under the federal securities laws).

Loss, Comment, *The Assault on Securities Act Section 12(2)*, 105 Harv. L. Rev., 908, 915-916 (1992). Rule 10b-5, therefore, cannot be used as a pretext for the judicial pruning of the express right of action under Section 12(2).

In addition, *Ballay*'s conclusion that Rule 10b-5 actions would be rendered "superfluous" failed to address key distinctions between Section 10(b) and Section 12(2). Most importantly, Section 12(2) applies only to "sellers," while Section 10(b) reaches a wider range of participants.

[20] It is beyond dispute that Section 10(b) overlaps Section 12(2) with respect to fraud in the primary market; nothing in the statute makes such an overlap on secondary markets transactions impermissible.

The broadly defined statutory terms "offer" and "sell" in Section 12(2) are "expansive enough to encompass the entire selling process, including the seller/agent transaction." *Pinter v. Dahl*, 486 U.S. 622, 643 (1988) (quoting *Naftalin*, 441 U.S. at 773).[21] *See also* IX Loss & Seligman, *Securities Regulation* 4227 (3d ed. 1992). Those who participate in a scheme to defraud but who remain completely outside of the actual purchaser-seller transaction might escape liability under Section 12(2). *Pinter* was concerned with reaching persons such as brokers who might act on the seller's behalf for profit. *See Pinter*, 486 U.S. at 654-655; *Wilson v. Saintine Exploration & Drilling Corp.*, 872 F.2d 1124, 1126 (2d Cir. 1989).[22] Numerous

[21] While *Pinter* dealt with Section 12(1), 15 U.S.C. § 77*l*(1), courts that have considered the question have applied the *Pinter* standard of "seller" to Section 12(2). *See Ryder Int'l Corp. v. First American Nat'l Bank*, 943 F.2d 1521, 1528 n. 11 (11th Cir. 1991).

[22] Indeed, the most vulnerable targets of Section 12(2) actions in the secondary market, as in *Ballay*, are brokers who profit by recommending and selling a particular security to their customers with false information. According to the SIA, innocent securities investors should bear the consequences of the *seller's* malfeasance because it would purportedly place too great a burden on securities sellers. (SIA Brief at 18-24.) Imposing a duty to exercise reasonable care, however, cannot be construed as burdensome. A securities broker

> cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendation, he implies that a reasonable investigation has been made and that his recommendation rests on conclusions based on such investigations.

Sec. & Exch. Comm'n v. Hasho, 784 F. Supp. 1059, 1107 (S.D.N.Y. 1992), quoting from *Hanly v. Sec. & Exch. Comm'n*, 415 F.2d 589,

courts have ruled that attorneys and accountants and others who remain outside of the sales process are not "sellers" under Section 12.[23] Rule 10b-5, on the other hand, proscribes all fraudulent conduct "in connection with" the purchase or sale of a security. While there must be a purchase or a sale of a security, violation of Rule 10b-5 is not limited to those involved in the sales process itself. The plaintiff in a Rule 10b-5 case need only establish that the defendant's fraud "touched" on the purchase or sale of a security. *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971); *Rudolph v. Arthur Andersen*

597 (2d Cir. 1969). *See also Sec. & Exch. Comm'n v. Great Lakes Equities, Co.* [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,685 at 98,206 (E.D. Mich. Sept. 4, 1990), *aff'd*, 12 F.3d 214 (6th Cir. 1993). Without a secondary market cause of action under 12(2), securities investors have no means under the federal securities laws to enforce this clear duty imposed on securities brokers. Certainly more due diligence is required for an initial public offering (SIA Brief at 19-20), but that is no reason to excuse reasonable care in the secondary market.

[23] *See, e.g., Wilson v. Saintine Exploration & Drilling Corp.*, 872 F.2d 1124, 1126-1127 (2d Cir. 1989) (attorney); *Moore v. Kayport Package Express, Inc.*, 885 F.2d 531, 537 (9th Cir. 1989) (attorney and accountant); *Royal Am. Managers, Inc. v. IRC Holding Corp.*, 885 F.2d 1011, 1017 (2d Cir. 1989) (attorney and director); *Ackerman v. Schwartz*, 947 F.2d 841, 845 (7th Cir. 1991) (attorney); *In re Crazy Eddie Sec. Lit.*, 714 F. Supp. 1285, 1293-1294 (E.D.N.Y. 1989) (accountant); *Loan v. Fed. Deposit Ins. Corp.*, 717 F. Supp. 964, 968 (D. Mass. 1989) (officers and directors); *Buford White Lumber Co. Profit Sharing & Sav. Plan & Trust v. Octagon Properties, Ltd.*, 740 F. Supp. 1553, 1558 (W.D. Okla. 1989) (law firm); *Zupnick v. Thompson Parking Partners*, [1990 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 95,388 at 96,912-13 (S.D.N.Y. 1990) (accountants), *appeal dismissed*, 989 F.2d 93 (2d Cir. 1993); *Sellin v. RX Plus, Inc.* 730 F. Supp. 1289, 1291-1294 (S.D.N.Y.1990) (attorney).

& Co., 800 F.2d 1040, 1046 (11th Cir. 1986), *cert. denied*, 480 U.S. 946 (1987). As this Court recently stated in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, ___ U.S. ___, 114 S. Ct. 1439, 1455, 128 L. Ed. 2d 119 (1994), "[a]ny person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met." Section 10(b), therefore, reaches numerous potential defendants who are not "sellers" in the Section 12 sense.[24] The suggestion that the secondary market cause of action under Section 12(2) renders Rule 10b-5 actions "superfluous" is therefore without merit.

D. THE PURPOSE AND EFFECT OF THE SECURITIES ACT OF 1933 SUPPORTS THE APPLICATION OF SECTION 12(2) TO SECONDARY MARKET TRADING.

Because the language of the statute is clear, this Court need not delve into the legislative history of the 1933 Act to determine the drafters' intent. Congress applied Section 12(2) to "[a]ny person who . . . offers or

[24] In a Rule 10b-5 "fraud-on-the-market" case, for example, the "seller" may not be responsible for misconduct that wrongfully inflates the market price of a security. *See Basic, Inc. v. Levinson*, 485 U.S. 224, 244 (1988) (" 'The market is interposed between the seller and buyer and, ideally, transmits information to the investor in the processed form of a market price.' ") (citation omitted).

sells a security" and this Court "must presume that Congress meant what it said." *Pinter*, 486 U.S. at 653. The unambiguous language of a statute can be the subject of an inquiry into legislative intent only when a contrary intention is "clearly expressed." *Reves v. Ernst & Young*, ___ U.S. ___, 113 S. Ct. 1163, 1169, 122 L. Ed. 2d 525 (1993). In both *Ballay* and *Pacific Dunlop*, the circuit courts considered legislative history and reached opposite conclusions. *See also Randall*, 478 U.S. at 657 (noting that the legislative history of Section 12(2) is "sparse"). Therefore, a *clearly* expressed legislative intent contrary to a broad interpretation of the statute is patently not available.

If legislative history is considered, the Seventh Circuit's analysis focusing on key distinctions between House and Senate drafts of the legislation soundly demonstrates that the language of Section 12(2) was intended to apply to both primary and secondary markets. *Pacific Dunlop*, 993 F.2d at 589-592. In contrast, *Ballay* relied upon a House Report accompanying the 1933 Act that noted that the bill "affects only new offerings of securities . . . [and] does not affect the ordinary redistribution of securities . . . " 925 F.2d at 690 (quoting H.R. No. 85, 73d Cong., 1st Sess. 7 (1933)). This general statement, directed to a draft of the 1933 Act as a whole, cannot be construed as specifically limiting the application of Section 12(2) – or for that matter Section 17(a) – to primary distributions. No one disputes that the 1933 Act was *primarily* concerned with initial distributions, *see Naftalin*, 441 U.S. at 778, but there are express exceptions which even *Ballay* recognized relative to Section 17(a). 925 F.2d at 692. Section 12(2), by its plain language, is another exception, the impact of which cannot be negated by

sweeping general statements addressed to the 1933 Act as a whole.

The SIA focuses on comments of various legislators in the House to the effect that secondary market abuses were not addressed by the House bill. (SIA Brief at 15-16.). The House bill, however, did not become law. *See Pacific Dunlop*, 993 F.2d at 592. Senate Bill 875 replaced the House bill and the pertinent language was changed to "any security." May 8, 1933, 77 Cong. Rec. 2996-3000 (1933) (contained in section 9 of the Senate version). Senator Norbeck's comments regarding the New York Stock Exchange do not indicate an intention to limit Section 12(2) to initial public offerings. (*See* SIA Brief at 17.) The Senator, addressing violations of rules by members of the New York Stock Exchange, stated that

> Their rules seemed to be aimed toward providing for what they consider square dealing between members of the exchange and to make sure of the solvency of members so that their obligations will not be unpaid. While strict rules have prevailed as to the conduct of members toward each other, only recently have they discovered that the public is also a party to stock-market transactions and has interests which should be protected. *It seems to be a new idea to think first of protecting the investor in the stock market. Until recently they had been operating under the idea that the "buyer should beware", but this bill proposes to place responsibility on the one who sells.*
>
> The pending bill does not in any way deal with the stock exchange. That matter has been left for subsequent and much-needed legislation. All the trouble, however, is not with the New York Stock Exchange, which is probably the best-regulated in the country. This may not be saying much, but it means something by comparison.

77 Cong. Rec. 3223 (emphasis added).[25] The Senator went on to discuss manipulative practices for "rigging the market." While subsequent, much-needed legislation was provided – *see* Section 9 of the 1934 Act, 15 U.S.C. § 78i – the Senator's comments did not suggest that the legislation before the Senate applied only to initial public offerings. On the contrary, he noted an intention to protect "the investor in the stock market" and that the bill proposed to place responsibility on the seller. Most importantly, the language of Section 12(2) which was finally adopted does not demonstrate a limitation to initial public offerings. *See Pacific Dunlop*, 993 F.2d at 592.

In *Pinter*, this Court reaffirmed that "[t]he ultimate question is one of congressional intent, not one of whether the Court thinks it can improve upon the statutory scheme Congress has enacted into law." 486 U.S. at 653 (quoting *Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979)). Given the clarity of Section 12(2) and corresponding legislative history, the SIA's "policy considerations" are of no moment. (SIA Brief at 18-29.). *See Pacific Dunlop*, 993 F.2d at 594-595. To the extent that policy considerations are pertinent, however, "the Court has recognized that Congress had 'broad remedial goals' in

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[25] *See also Wilko v. Swan*, 346 U.S. 427, 430-31 (1953). Absent a broad interpretation of Section 12(2), secondary market purchasers would be returned to the days of *caveat emptor*. In other words, "let the seller also beware only if it is an initial public offering."

enacting the securities laws and providing civil remedies." *Pinter*, 486 U.S. at 653 (citations omitted). Securities law provisions are construed "not technically and restrictively, but flexibly to effectuate [their] remedial purposes." *Id.* (quoting *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972) and *Sec. & Exch. Comm'n v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963)). The remedial purposes of Section 12(2) are not furthered by restricting its application to initial public offerings.[26] While this Court has not hesitated to terminate judicially implied rights of action, *see Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, ___ U.S. ___, 114 S. Ct. 1439, 128 L. Ed. 2d 119 (1994), it should be hesitant to cut off express rights of action which would require the Court to imply a *limitation* not spelled out by Congress.

IV. CONCLUSION

The Seventh Circuit's holding in *Pacific Dunlop* should be upheld in its entirety and the Third Circuit's

[26] While it may be much more convenient to securities dealers (especially those bent on wrongdoing) to restrict Section 12(2) to primary markets, this Court, has stated that "ease of application alone is not an excuse for ignoring the purposes of the Securities Acts and Congress' policy decisions." *Basic Inc. v. Levinson*, 485 U.S. 224, 236 (1988).

contrary holding in *Ballay* should be overruled. The Seventh Circuit's order in this case, relying upon *Pacific Dunlop*, should be affirmed.

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Respectfully submitted,

PATRICK E. CAFFERTY
(Counsel of Record)
MILLER FAUCHER CHERTOW
CAFFERTY AND WEXLER
30 North LaSalle St.
Suite 3200
Chicago, IL 60602
Telephone: 312/782-4880

JONATHAN W. CUNEO
General Counsel
NASCAT
317 Massachusetts Avenue, N.E.
Suite 300
Washington, D.C. 20002
Telephone: 202/789-3960

Counsel for Amicus Curiae, National Association of Securities and Commercial Law Attorneys (NASCAT)